PRO-POOR ECONOMIC GROWTH RESEARCH STUDIES
CONTRACT NO. PCE-I-02-00-00015-00

# Finance and Pro-Poor Growth

Deliverable 1: Research and Results Dissemination Plan and Time Line
Deliverable 2: Website
Deliverable 3: Pro-Poor Economic Growth: A Review of Recent Literature
Deliverable 4: Poverty-Problem Countries Typologies
Deliverable 5: Selection Criteria for Pro-Poor Economic Growth Policies
Deliverable 6: Preliminary Policy Recommendations
Deliverable 7: Poverty Reduction Strategy Papers: A Preliminary Analysis of the Process and Outputs
Deliverable 8: Meeting: Presentation of Phase One Results
Deliverable 9: Workshop: Phase One Results, Preliminary Findings, and Planned Research
Deliverable 10: Poverty, Economic Growth, and Development Policies and Activities: A Case Study of:

- *Brazil*
- *Egypt*
- *Indonesia*
- *Peru*
- *Uganda*
- *Ukraine*
- *Zambia*
- *Sri Lanka*

Deliverable 11: Pro-Poor (Sector) Policies, Reforms and Activities

- *Agriculture*
- *Education*
- *Finance*

Deliverable 12: Pro-Poor Economic Growth Policies, Reforms, and Activities
Deliverable 13: Workshop: Research Findings and Implications for USAID Programming
Deliverable 14: Pro-Poor Economic Growth and Poverty Reducing Policies, Reforms, and Activities (Guidance Manual)
Deliverable 15: Workshop: Final Findings and Presentation of Guidance Manual
Deliverable 16: Dissemination of Findings of Guidance Manual
Deliverable 17: Final Project Report
Deliverable 18: Issues Papers on:

VOLUME I:
- *Health*
- *HIV/AIDS*
- *Privatization*

VOLUME II:
- *Conflict and Post-Conflict Recovery*
- *The Environment*
- *Gender*

# Finance and Pro-Poor Growth

by

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March 2004

*The Pro-Poor Economic Growth Research Studies and Guidance Manual Activity, implemented by Development Alternatives, Inc. and Boston Institute for Developing Economies, is funded by the Bureau for Economic Growth, Agriculture, and Trade, U.S. Agency for International Development, under the terms of Contract No. PCE-I-02-00-00015-00, Task Order #2. This document represents Deliverable #11 under this task order.*

# TABLE OF CONTENTS

# LIST OF TABLES AND FIGURES

Table

# EXECUTIVE SUMMARY

## THE ROLE OF FINANCE IN PRO-POOR GROWTH

An effective and efficient financial system speeds growth because it (a) encourages a high level of savings, (b) shifts capital among individuals and firms to promote its efficient use, and (c) keeps the real costs of such transfer to a minimum. Many developing country financial systems are weak on each of these counts, making the capital market arguably the least efficient of the major markets. The imperfections are the result of complexity, opaqueness, incomplete information, and weak regulation.

For a financial system to contribute not just to growth but to pro-poor growth, much of the challenge lies in the effective provision of credit, savings facilities and other financial services to lower income people and to smaller-scale firms. Savings facilities which improve the returns to savers have a direct positive effect on their income. In addition, ready and secure access to investment by entrepreneurs without access to the formal financial system increase consumption ability by families suffering unpredictable shocks to their income or unavoidable expenditures.

Along with channelling funds to the relatively small firms and farms which operate labor-intensively at decent levels of efficiency and productivity, a good financial system identifies and funds smaller firms that are at growth thresholds which can be hurdled with the help of external finance. This system does not channel large flows of resources to socially unproductive investments such as the speculative purchase of assets in fixed supply, like real estate.

A prototype pro-poor financial system has a deep and broad formal financial sector, achieving wide coverage among both savers and potential borrowers. The payoffs to such depth/breadth are suggested, inter alia, by a large estimated poverty reduction effect of the policy-induced expansion of rural banking in India, by estimates of the poverty impact of the major microfinance institutions in Bangladesh and by the spectacular growth of deposits and lending to smaller firms by the Bank Rayat Indonesia and their impacts on the incomes of the near-poor.

It is likely that improving access of the poor to good savings vehicles is on average more important than improving their access to credit. Though better credit access for SMEs raises their performance, the magnitude of such benefits has not yet been well measured. When the formal financial sector cannot achieve a high level of breadth and depth, the role of the informal "curb market" and of trade credit may be especially important.

## PROBLEMS AND SHORTCOMINGS OF FINANCE SYSTEMS RESULTING GOVERNMENT INTERVENTION

At present, most developing country financial systems fall far short of the ideal of efficiency and pro-poor bias in a number of ways:

i) Large gaps between borrowing and lending rates and related high administrative costs,
ii) Unequal access to the formal financial sector among groups of borrowers. Large well-connected firms are often much better served than equally efficient small ones, and
iii) Serious instability, usually related to international flows of short term capital. Though informal financial institutions perform valuable functions, they typically cannot offset the failings of the formal sector.

Developing country governments traditionally respond to the perceived (and usually real) failings of their financial systems with a combination of direct government intervention, usually through public banks, and with high levels of control through interest rate ceilings and restrictions on how financial institutions could invest their funds. Some of the intervention is directly designed to improve credit access of such typically excluded sectors as small-scale agriculture and SMEs, taking the form of special state-owned banks providing finance to these sectors usually at below market interest rates.

This approach however has suffered from serious shortcomings, including inefficiency and “financial repression”, that is, a smaller financial sector which is less capable of fulfilling its intermediation function. Publicly-owned banks are usually poor at obtaining repayment of loans; the government officials who administered these programs are not hard-hearted bankers who insisted on repayments but bureaucrats subject to political pressures and bribery. With interest rates subsidized and repayment often optional, government credit often turns into a patronage vehicle. Meanwhile, low deposit rates discourage savings.

The last couple of decades have seen significant changes in the financial system of many developing countries, most notably the market-oriented financial sector reforms, the dramatic growth of microfinance and, in some countries, the growth of stock markets, often fuelled by an inflow of foreign capital (and related to the financial reforms).

## FINANCIAL REFORMS AND THEIR EXPECTED BENEFITS

The reforms of the last few decades have aimed to lift the financial repression and associated inefficiency of the previous system, to induce higher levels of savings, and to move closer to a free market allocation of funds. The long term effects are not yet clear, partly because financial liberalization, especially the opening up to international financial markets has led to a large number of financial crises. One hope was that a more market-based system would reduce the large-firm bias to the benefit of SMEs. Evidence on this is mixed.

Though the impact on the rate and pro-poorness of economic growth is not well understood in terms of financial development or recent financial reforms, some elements are clear or reasonably so. A well developed banking system appears to be more supportive of SME development than stock-market growth. Most public banks, in their pre-reform structure, needed to be terminated or severely transformed in their operating practices. Since some do perform well, a total exclusion of such institutions was not warranted.

Avoiding low, subsidized interest rates is important both to screen out bad risks and to inculcate borrower responsibility. Public support (subsidies) to banks and other financial institutions may be justified when associated with start-up and learning how to perform worthwhile new lending activities. For many countries openness of the financial system to international short-term capital flows is very dangerous; policy needs to address this systemic problem. In short, some but not all of the prescriptions in the typical financial reform tend to be positive in their impacts.

## MICROFINANCE: ITS IMPACT ON THE POOR

Microfinance has raised the credit access of many very small enterprises. Together with other institutions, it has contributed to some significant improvements in savings facilities for lower income people. In the course of the microfinance boom over the last decades it has been confirmed that many financial institutions can provide small loans at much lower cost than had earlier been predicted and with repayment rates much higher than commonly expected. At their best, microfinance systems can have significantly positive direct impacts on a large number of poor and near-poor people, through raising their incomes, allowing consumption smoothing in the face of exogenous income or expenditure shocks, and facilitating savings.

Among the main keys to such success are the use of high enough interest rates to allow financial sustainability of the lending institution and management techniques and borrower screening to keep costs down. There has been a recent trend towards commercialization in some parts of the world, notably Latin America. There is also a shift towards client-driven systems as it becomes more important to adjust products to client needs.

## SUMMING-UP: FINANCE AND PRO-POOR GROWTH

The broad objective of pro-poor financial policies is the construction of a stable and efficient financial system which is not readily vulnerable to exogenous shocks (these tend to have very negative impacts on the poor by producing recessions and restricting credit access of SMEs) and which serves the needs of lower-income people well through the breadth of savings and lending facilities it makes available. A general principle is that policy interventions should respect the roles of markets and incentives (therefore normally limiting subsidies to start-up costs of one sort or another). Specific elements of the policy package, whose composition should reflect the structure and needs of each individual country, will often include improved regulation and supervision of the financial system as a whole; policies to induce increased coverage of the banking system in poorer regions or to poorer groups of the population; support for efficient microfinance programs; and support for improved credit access of SMEs. The specifics of the appropriate support policies will vary by context.

# CHAPTER ONE
# THE FINANCIAL SYSTEM AND PRO-POOR GROWTH

A country's financial system consists of all of the institutions and practices related to financial transactions of any sort. In helping to determine the rate of savings and how those savings are allocated among different investment options affects the rate of economic growth. It affects poverty reduction through both the rate and the pattern of growth; the latter involves, for example, the degree of concentration of savings among the rich and the relative success of smaller versus larger enterprises. The savings allocation process involves financial intermediation, a mechanism of central interest to us here.

This paper begins (Chapter One) with a broad look at the main features and limitations of developing country financial systems from the perspective of pro-poor growth. Chapter Two reviews the empirical evidence and the thinking on how financial structure and its evolution affects growth and the pro-poorness of that growth, with attention to the financing needs of SMEs, the impacts of stock markets, and the effects of the financial and trade liberalization processes of the last couple of decades. Chapter Three focuses specifically on the contribution of microfinance to pro-poor growth, and Chapter Four presents policy recommendations.

## A. Financial Intermediation: What Is It?

Financial intermediation is the process by which funds are transferred from their initial holder to the user through an intermediary (for example, a bank or a stock market). The ultimate use of such transferred funds may be either investment or consumption. The main benefit of a good financial intermediation system is a more **rapid increase in the country's capital stock**. Another function is the promotion of **technological innovation**. New technologies are often embodied in capital equipment, in which case the two functions go together. Since new technologies often entail risks or large fixed investments, a strong financial system helps to deal with these challenges. Finally, financial intermediation provides an important mechanism of consumption smoothing and risk management for individuals.

## B. The Challenge for Pro-Poor Growth Finance

**An efficient financial system (a) encourages a high level of savings, (b) shifts capital to those who can best use it**[1]**, and (c) keeps the real costs of this transfer to a minimum** (these costs include real resources used up in the transfer activity). Such a system has a direct

[1] The performance of a financial sector can be measured in terms of the three tasks just mentioned. Where the sole criterion is contribution to growth, then factor (b), allocation of capital, would be judged solely by whether the allocation of capital achieved that objective. Where pro-poor growth is the objective, it would be judged by whether capital gets to the sectors which achieve that goal.

positive impact on the rate of economic growth, which in turn reduces poverty. A system's success on each of these counts is determined by a combination of the following:

- Exogenous conditions (structural features of the economy, international conditions) that have become especially important to financial sector performance in the era of financial liberalization. Volatile international capital flows can be a serious threat.
- Public policies (both in the finance area and more generally).
- The structure and functioning of the financial institutions themselves. Incentive structures matter, as do the degree and character of competition among financial institutions. In the case of smaller enterprise, a frequent weakness is lack of the sort of skills that help to evaluate small borrowers and to interact well with them.

**Since domestic macroeconomic policy operates largely through the financial sector, the way it is handled can have major impacts on and impose serious limitations on the effectiveness of the latter**. A constraint on the performance of a financial system derives from the fact that the real interest rate is a tool of macroeconomic policy as well as the price at which funds change hands between savers and borrowers. A high interest rate designed to curtail aggregate demand can be a burden to borrowers such as SMEs, who typically are the first to lose access to the formal credit market. It also constitutes a socially unfortunate inducement to small entrepreneurs to shift from real productive assets to financial ones. That is, to invest in bonds or keep their money in savings accounts or time deposits rather than invest directly in productive assets. By reducing real output this diversion of savings may diminish the effectiveness of the high interest rate in curtailing an excess demand.

Public policy also has a major influence on how well the financial sector works through its direct involvement (public banks, etc.), its regulation and supervision of the financial institutions, and its management of macroeconomic policy.

Table 1 lists a number of the frequently cited weaknesses of developing country financial systems, their symptoms and/or causes and possible remedies discussed in this and subsequent chapters. Some of the various possible causal links among items in the different columns are identified below, though not in a comprehensive way.

All financial systems fall substantially short of perfection. In most developing countries they fall very far short, making the capital market arguably less efficient than the labor market, the land market, and nearly all of the goods markets. Poor performance tends to be the result of the complexity, opaqueness, incomplete information, and weak regulation of most financial markets. These underlying sources of capital market malfunctioning typically show up in a slower rate of economic growth through their impacts on each of the functions of the financial system:

**Table 1: Results, Causes and Possible Remedies for Financial Sector Weaknesses**

| Undesirable Outcomes | Causes/ Symptoms | Possible Remedies |
|---|---|---|
| 1. Low Savings or savings transfer/Slow growth | Possible Causes:<br>1. Exogenous conditions<br>a) High rate of inflation<br>b) Financial volatility | 1. Better macro policies<br>2. Microfinance development<br>3. Better support for SME lending |
| 2. Inefficient allocation of transferred savings<br>a) too little credit to smaller firms<br>b) too much credit to speculative uses | 2. Size, structure and functioning of the formal financial sector<br>a) Weakness or unwillingness of financial institutions to achieve wide lending coverage by income level and firm size<br>b) close linkages with big business<br>c) monopoly/oligopoly and lack of incentive | 4. Other ways to broaden coverage of the banking system<br>5. Better regulation and supervision of the financial system<br>6. Stock market development |
| 3. High resource cost in transfer process | 3. Policies<br>a) Over regulation/financial repression<br>b) Inadequate regulation<br>c) Weak support for broadening of coverage to smaller enterprise and poorer people<br><br>Symptoms:<br>a) Low financial ratios/lack of financial depth<br>b) Limited reach of the financial system within the population and to smaller enterprises<br>c) High lending to speculative uses or clearly bad projects<br>d) Vulnerability to financial crisis | 7. Financial liberalization<br>8. Financial opening to international markets |

1. **Low savings rates**, which plague many developing countries, and whose implications for pro-poor growth are most serious when, as is often the case, poor people do not have access to attractive savings vehicles. Ability to save has a number of specific benefits to lower income people, beyond simply making them less poor. Most new small firms do not have access to formal sector credit and rely mainly on their own savings and those of relatives and friends to get started. Any institution that facilitates such savings thus contributes not only to aggregate savings and investment but especially to the investment of entrepreneurs without access to the formal financial system. Families also need savings to deal with exogenous shocks to their income or expenditure streams.

The degree of consumption smoothing over seasons, within the year, and across years, in response to very great income fluctuations is higher than was supposed until recently. The lack of good insurance and credit markets forces farmers, especially small ones, to hold savings in relatively unproductive forms (that is, to maintain inefficient asset portfolios—see Rosenzweig, 2001). The same is probably true to some degree of many other types of small businesses. It is possible that the simple presence of a savings institution can help to inculcate the savings habit in people, another benefit from such institutions. In some (perhaps most) cases it is likely that improving access of lower income people to good savings vehicles is more important than improving their access to credit.

There are, of course, a variety of savings vehicles in any country. Cash is an attractive form of wealth in countries with low inflation rates, but otherwise a very costly one. Other common forms of wealth in developing countries include hard currency bills, real estate, cattle and other productive assets, a supply of staple foods, home improvements and severance pay packages. Some of these may play a useful role as a store of value while maintaining liquidity, but often the unit of purchase is too large or the market too fragmented for them to work well for the small saver. In that case, access to other convenient financial assets takes on special importance. Where inflation rules cash out as a good option it becomes especially important that some other financial assets give reasonably decent returns together with liquidity. Savings deposits are the obvious candidate for small savers who are not in a position to trade in more complicated assets. The reach of the banking system or some surrogate like credit unions or postal savings branches can be pivotal in this regard.

2. **Ineffective allocation of savings among users**. Three often mentioned examples of credit misallocation are under-financing of labor-intensive enterprises (of special relevance here); excessive allocation to well-connected larger firms; and excessive allocation to speculative activities.[2] **From a pro-poor perspective it is important that the financial system allocate sufficient funds to labor-intensive production activities** such as the clothing export industry or the labor-intensive production of a staple crop **rather than to a capital and skills-intensive activities** of similar private profitability.

[2] This last form of inefficiency occurs when a financial system channels resources towards the purchase of fixed supply assets (land, real estate, and sometimes stocks and bonds when in fixed supply). This leads to price increases of these assets, which in turn lead to a "Pigou" effect in which dissaving by the (now richer) holders of those assets is encouraged, cancelling out the savings which flowed into the system in the first place. This is one of a variety of situations in which the private returns to the financial investment that occurs may diverge widely from the social returns. The existence of the Pigou effect does not imply, though, that credit should never be supplied to purchasers of fixed-supply assets like real estate. When, for example, the purchaser is a small or medium entrepreneur who will use the asset in production, such finance can be beneficial not only to the borrower but to society as a whole. What is not desirable is such credit provided for essentially speculative purposes. Factors contributing to inefficiency include incompetence of financial intermediaries and interconnectedness among markets, as where the owners of a bank also own various non-financial enterprises and have an interest in channeling funds to those enterprises rather than to their competitors.

The **two main correlates of unskilled labor intensity are type of product** (clothing vs. steel) **and size of firm** (smaller vs. larger). These two features tend also to be correlated with each other; thus labor-intensive industries like clothing tend to have a higher share of workers in small firms than do capital-intensive industries like steel. The fact that SMEs are more labor intensive than large enterprise is a general reason to prefer that they play a large role in any economy as long as wages are low and/or unemployment (whether open or disguised) is high. That preference would be especially strong in cases where the opportunity cost of labor is even lower than the wage.

An especially low opportunity cost of labor can come about because of chronic labor surplus conditions or when an economy is undergoing recession or structural adjustment of some sort. Whether the microenterprise sector plays the principal labor-absorbing role or whether it is the SME sector, there is a strong logic to allocating as much capital to these sectors as they can employ with reasonable productivity. The two sectors between them, together with small-scale agriculture, employ the majority of the labor force in virtually all low and middle-income developing countries. They also account for a substantial, albeit lower, share of GDP.[3]

The economy-wide social payoff to the flow of finance to smaller firms is greatest when additional finance would contribute greatly to the growth and/or productivity level of the firm but is not available from internal resources. Credit that facilitated the adoption of Green Revolution varieties of rice by low income farmers would fall into this category.

**Unequal access to finance by size and technology of borrower is the norm in developing countries, with** the formal financial system serving large, well-connected firms while smaller ones are much more on their own.[4] Although there has been a general deepening of financial systems in many parts of the Third World, this state of affairs continues, especially in poorer countries with less developed financial systems.[5]

Whatever a country's level of financial development, most SMEs are initially financed largely from internal sources, in the form of equity investments by owner-managers, complemented fairly frequently by either investments or loans from friends and relatives.[6] The available external finance comes mainly from informal or curb market sources and is

[3] Westley and Shaffer (1999) report that microenterprise accounts for about 20 percent of GDP and micro plus small enterprise for about 40 percent in Brazil, Mexico, Belize and the Dominican Republic.

[4] It has been widely confirmed that access to credit generally rises with both firm size and age of firm (each being associated positively when the other variable is held constant). In Mexico, for example, as of the year 2000, funds from commercial, foreign and development banks together constituted about 20 percent of the total for small firms, increasing to about 30 percent in medium size firms and to 38 percent in large firms (Berry and Ruiz, 2003, 208).

[5] Quantitative information remains very partial, however, since few countries maintain good flow of funds accounts and almost none provide enough detail to provide solid information on how the credit status of various size categories of firms has been changing.

[6] See, for example, Cortes et al., 1987, 133.

short-term in nature. Trade credit may be especially important at this stage for some firms. In view of the difficulties that they face in obtaining finance for start-up, SMEs often must be very adept at minimizing their capital requirements. As the firm grows in size and capabilities, or even just with the passage of time, its access to external sources of finance tends to improve. At first this may be limited mainly to curb market sources at high interest rates but, later on, commercial bank or collective sources of finance become available. These are often at considerably lower rates[7] and under generally more favorable conditions. In more developed financial markets, a few SMEs may even gain access to finance through the bond and equity markets via their over-the-counter component.

As well as **receiving less credit** or more generally less external financing (relative to the size of the operation) than do large firms, many small firms **pay high interest rates to informal sector lenders** when they do borrow. A considerable share of them (greater the smaller and less well established the firm) **voice the view that credit is important to them, and that their firm would prosper better if it could get such credit or get more of it or under better conditions**. Typical complaints refer not only to inadequate access, but also to lack of timeliness, excessively complicated and/or time consuming bureaucratic procedures (especially in public financial institutions), high interest rates, and excessive collateral required. Those smaller firms that are able to obtain short-term external financing sometimes use the funds for long-term purposes such as the purchase of capital equipment, increasing the risk of default to both borrower and creditor.

3. **High transactions costs**. When the transactions costs involved in transferring the funds and undertaking the needed checks on the reliability of borrowers are high, the potential gains from transfer are diminished in two ways. First, resources are used up in effecting the transfer, and second, some savers may be discouraged due to the low return and some investors may be discouraged due to the high cost of the funds. In total, less investment occurs than might have done with lower transactions costs. **The evidence from the formal financial systems of most developing countries points to large gaps between borrowing and lending rates and high total administrative costs** in relation to the amount of funds intermediated. One symptom of weak performance of a country's financial system, and an indication of how limited are the options available to many, is the fact that savers are often willing to accept negative real interest rates, not just when inflation unpredictably eats away the value of deposits, but more generally, as exemplified by the mobile banks which charge for the safe-keeping of monies (Bixby, 2000).

The severe weaknesses of most developing country capital markets, both overall and even more in their capacities to serve the needs of lower income people, probably have important

[7] In Thailand the share of self-financing in SME expansion was about 50 percent, down from 70-80 percent for start-up (Akrasanee et. al., 1986, 226). In the Philippines, only eight percent of a sample of 64 enterprises were able to borrow from financial institutions at start-up, but this share subsequently rose to almost 50 percent (Anderson and Khambata, 1981, 110-112). In Colombia the share of self-finance in the investment of a sample of 36 food processing firms fell from 85 percent for those less than six years old to 66 percent for those more than 15 years old (Cortes et. al., 1987, 133 and 217).

growth and poverty costs. The other side of this coin is that to the extent that such weaknesses can be resolved the benefits may be quite large.

## C. The Informal-Formal Financial Spectrum

An up-to-date view of the financial system as a whole needs to distinguish at least five points along the informal-formal spectrum: the very basic informal market (for example, friends and relatives, other local lenders) whose functioning is based on personal knowledge and trust; the higher-level informal (curb) market which operates outside some or all legal constraints but on a larger more organized basis; microfinance institutions; banks and any other financial institutions which develop considerable capacity to lend to smaller borrowers (often but by no means always the banks involved are relatively small or locally-focused ones); large banks and other institutions which provide capital mainly to large enterprises.

There are various types of overlap across these groups. Nevertheless, the relative magnitude of the flow of funds through each of them affects the relative access of groups of enterprises which differ in size and associated characteristics. How much that relative access is affected depends on how much the various groups of intermediaries are substitutes for each other and how much they are complements; both types of relationship can be beneficial to overall performance and to the welfare of smaller borrowers.

One form of substitutability involves those potential borrowers who are near the borderline between the natural clientele of one group of intermediaries and another; thus there are some firms which may be clients of microfinance institutions or may borrow from commercial banks which lend to small borrowers. For this group of borrowers it may not matter much whether the microfinance institutions can do a lot of lending or not. Groups of intermediates complement each other when one acts as the retailer for another. Thus some NGO microcredit institutions borrow from commercial banks and on-lend to their clients. In that case, the inability of the banks to reach the ultimate borrowers directly becomes less of an issue. Another form of complementarity occurs when experience with one type of intermediary "prepares" a client for the next level, as when firms "graduate" from microcredit to regular bank credit.

Finally, complementarity occurs when an individual borrows (or can borrow when the need arises) from a variety of types of lenders. Cohen (2001) emphasizes the range of financial services used by many microcredit clients and the importance that microcredit systems and the products they provide be designed with that fact in mind.

## D. Are Developing Country Financial Systems Becoming Better at Facilitating Pro-Poor Growth?

It is not surprising that the financial systems of most developing countries fall rather far short of the ideal. The bigger questions are how far they are from the ideal and whether they are moving in the right direction at an acceptable rate. One way of assessing this is by exploring recent trends in developing countries themselves. The other is by looking at the current state of play in industrialized countries, whose patterns give many leads as to the range of options which will confront developing countries in the future.

## Trends in the External Financing of Smaller Firms in Developing Countries

Are past weaknesses in developing country financial systems on the way to being resolved? In the case of microenterprise, an enormous advance (from a level near zero) has occurred. The remaining question is how much farther it will go. Although the share of all microenterprises with credit access is still small in many countries, since it is not clear what percent could benefit from credit, it is difficult to guess what a reasonable target for coverage would be. Some do not need credit; others have other sources which are adequate to their needs.

Figures presented by Westley (2001) suggest that four to seven percent of the estimated 60 million or so microenterprises in Latin America have microcredit at a given time, implying that a somewhat higher share (at least five to 10 percent) are in a position to obtain credit should they want it.[8] In Bangladesh, the home of several huge MFIs, Khandker (1998, 60) reports that an impressive 20 percent of the population benefits from microcredit programs, or about 45 percent of those eligible to participate (presumably those with microenterprises).

Lack of reliable overtime information on the credit status of various size categories of firms leaves it unclear whether SMEs typically fare better than twenty years ago or not. The forays of commercial banks and other specialized formal profit-oriented financial institutions into or close to the microenterprise area have been increasingly frequent in recent years, giving some grounds for optimism that SME access has been increasing. Jenkins (2000) argues that profit-motivated commercial bank lending to both SMEs and microenterprise is now very prevalent in many developing countries; the evidence in fact relates more to SMEs.[9]

The advance of microfinance and, in some countries, the extension of commercial bank branch systems have improved the savings options of many lower income people, but lack of adequate facilities remains a major problem in many others. The experience of BRI (Bank Rakyat Indonesia, the People's Bank of Indonesia) in Indonesia since 1984 provides a dramatic example of the great unmet demand for highly liquid small savings deposits; over

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[8] Westley (2001, 5) estimates that only 2.6 percent of a base calculation of 59 million microenterprises have formal or semiformal credit from a microfinance institution. Adding in the enterprises with loans from credit unions, allowing for failure of the data to identify some credit recipients, and assuming a few firms have credit from both sources suggests the four to seven percent range noted above. McLean and Olsson (2002) report that 150,000 of a total of 550,000 Salvadorian small-scale entrepreneurs have access to small loans.

[9] In the source used by Jenkins loans of US$11,000-100,000 are defined as small to medium while those of up to US$10,000 are defined as micro. Data from a recent Micro banking Bulletin (Issue No. 8, Nov. 2002) show that for the large Asian microfinance institutions (with nearly 7 million active borrowers) the average loan size is US$153. For Latin America average loan size is $1,343 and for Africa $303. Most of the loans classified in this source as microcredit would normally be thought of as SME credit. Unfortunately data are not presented on the actual size of borrowing firms.

the period up to 2002 BRI built up accumulated small savings deposits totaling about three percent of GDP from essentially zero.

## Patterns of Finance for Small Enterprise in Industrial Countries

The current structure of financial systems in industrial countries provides a useful point of reference in considering how far certain features and capabilities may evolve. Though there are differences of degree, there is a general similarity between the nature of funding for small firms in developed and in developing countries, as the following points reveal.

1. The **external finance** to which smaller firms have recourse is **overwhelmingly from the banks**; in Britain, even for microenterprises with less than 10 workers about half had bank credit as of 1987-90 (Mason, 1998, 248); for middle sized firms of 100-199 workers this figure was 61 percent. The former figure is well above that for the typical LDC, presumably due to a combination of the greater capacity of the banking system (including availability of credit cards), the greater modernity of the small firm, and (perhaps) public policy.

2. **Banks do not appear to make large profits out of their lending to small firms**. A 1992 study by the Bank of England reported an average profit margin on loans to small firms of only 2.96 percent (Mason, 1998, 253).[10] If such figures are typical, it may reflect a tendency for banks to push their way up the "risk scale" among SME borrowers until on average the profits are low, the result, for example, of pressure from governments to better serve SMEs. It may be, however, that these profit figures provide an unduly pessimistic picture. Anecdotally bankers indicate that they look at the profitability of the entire relationship, not just of the loans. Thus when SMEs keep funds on deposit with the bank rather than investing them in other financial instruments (as would the treasury department of a large firm) the overall relationship may be more profitable than the profit figures suggest.[11]

3. The emphasis on **collateral** appears to be as great in industrial country bank lending to SMEs as in developing countries. Profit figures like those just cited make it easy to see why banks put such a premium on collateral. Not only does it provide a way for the bank to reduce loss when the loan goes bad, but the borrower's willingness to put up collateral also signals to the banks that these small entrepreneurs are confident in their projects.

4. The **credit line** has been the most common type of loan for small firms in the U.K. (Mason, 1998, 248) though banks have discouraged its use on the grounds that many small firms were in fact using for fixed capital investment a form of credit designed for working capital. The credit line is also popular in many developing countries; there too it has been widely noted that short-term credit is often used for long run needs, since it is the only external funding available.

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[10] Unfortunately not many studies have attempted to isolate profit margins by size of borrower.

[11] I am indebted to Mary Miller for this observation.

5. **Leasing** (rental with option to buy an asset like machinery), which allows the firm to use an asset without having to borrow to purchase it, is more common in industrial than in developing countries. In the U.K. it has been the second most prevalent source of funds, with a third of microenterprises and about half of SMEs resorting to it. Factoring, or the sale of one's accounts receivable at a discount to a financial company in exchange for cash, was used by only 3.7 percent of microenterprises and roughly 7.5 percent of SMEs in the U.K. (Mason, 1998, 248).

6. In many countries, including the U.K., Canada, Japan, Germany and the United States, governments have created **guarantee programs** for the lenders to SMEs. The borrowers pay a fee above the regular interest rate to cover this cost. Riding (1996) suggests that non-compliance is reduced if the guarantee is around 50 percent, which allows the fee to be low enough to avoid a lot of adverse selection.[12] The level of noncompliance in the U.K., together with the level of the guarantee (70-80 percent) has made it hard for the government to control the costs of the program (Storey, 1994).

7. **Venture capital** is a way of dealing with a situation where real or perceived project risk is relatively high. The venture capitalist specializes in assessing risky situations, provides technical assistance as appropriate, and shares the profits. Though venture capital companies receive a considerable amount of attention, in fact by far the main source of outside capital for small firms wanting to increase capital rapidly is the informal market for risk capital, rich people who know and are willing to collaborate with the entrepreneur (Mason, 1998, 269). In the United States, it is estimated that this market finances between 15 and 40 times as many companies as the institutional risk capital market (Wetzel and Freear, 1996; Gaston, 1989). Usually these "business angels" are participating investors, supplying business skills, experience and contacts to the firm supported. They are motivated by the desire for a capital gain but also sometimes by altruism or the itch to be involved in an entrepreneurial activity. There is, unsurprisingly, a general lack of accessible information to help bring the two parties together. In some countries networks of business angels are being developed to provide a better flow of information between the two sides (Harrison and Mason, 1996).

8. The experience of countries like Canada suggests that greater **competition among banks** can be beneficial to the SME sector. The 1980s saw a big increase in the number of chartered banks, which contributed to the introduction of a wider range of financing modes, expertise and management directed at the smaller firms. Now most chartered banks do have specialized credit services for SMEs. In two provinces where credit unions increased their activities, borrowing conditions seemed to improve for the SMEs. That competition brought lower collateral requirements, a chief concern of small business owners (Cleroux, 1989, 85).

[12] "Adverse selection" occurs when the character of an arrangement, such as that between the bank and its borrowers, discourages good clients and leaves those which are less likely to fulfill the contract.

# CHAPTER TWO
# HOW DOES FINANCE AFFECT THE PATTERN OF DEVELOPMENT AND THE REDUCTION OF POVERTY? THE EMPIRICIAL EVIDENCE

Economic logic suggests that both the size/depth and the structure of a country's financial system matter to economic growth and to the pro-poor quality of that growth. Financial development that promotes economic growth will usually reduce poverty. For a developing country's financial system to contribute to pro-poor growth, much of the challenge lies in the effective provision of credit, savings facilities and other financial services to lower income people and to smaller scale firms.

## A. HOW MUCH DOES A GOOD FINANCIAL SYSTEM CONTRIBUTE TO ECONOMIC GROWTH?

Because rapid growth tends to help poor people, the impact of a financial system on growth is relevant to its impact on poverty. There is a relatively close statistical correlation between indicators of financial depth and economic development, both over time and across countries. But such evidence is not conclusive proof that financial development is an important contributing factor to growth, partly because rising incomes and other correlates of development would be expected to contribute to financial development, that is, there is causation in both directions between these variables.

The growth benefits of financial development, however large they may be, probably vary substantially both across countries and by stage of development; they may be small or negative in some settings. It is likely that some elements of what is broadly referred to as financial development are the sources of benefits while others cause losses. More generally, the qualitative characteristics of financial systems vary a good deal and these characteristics may be as important to the net benefits resulting, as are "quantity" measures like the ratio of financial assets to real wealth in a country. But the main conclusion from the available evidence is that the impacts of financial development on overall economic growth are too little understood to permit useful policy guidelines at this point.

## B. WHAT CONSTITUTES A PRO-POOR FINANCIAL SYSTEM? EVIDENCE ON THE GENERAL BENEFITS OF "FINANCIAL INCLUSIVENESS"

While there is still serious debate on what financial structure is likely to generate the fastest overall growth, the features that are reliably pro-poor are easier to specify. Most important for the poor is the depth of the financial system, providing wide and helpful coverage among both savers and potential borrowers.

Countries with greater financial depth for their per capita incomes are more egalitarian. That is as would be expected if that greater financial depth essentially reflected the difference between a narrow exclusive financial system, used primarily by economic elite, and a broad, inclusive financial system, in which formal financial assets and instruments are much more widely spread within the population. In that broad, inclusive scenario, savings deposits are held by a high share of families and credit gets to microenterprise and SMEs rather than just to larger firms. This hypothesis is supported by cross-country analyses of the determinants of income inequality. Li, Squire and Zou (1998) find the ratio of broad money (M2) to GDP to be significantly and negatively correlated with the Gini coefficient of inequality.

Financial inclusiveness may be the result of financial depth which is not particularly related to policy decisions or it may be, at least to some extent, the result of policy. The "Indian social banking experiment" provides an example of how policy can push financial services out to more of the poor than would have occurred under a more laissez-faire approach.[13] Burgess and Pande's (2003) recent analysis of this experiment[14] provides the strongest evidence to date that such expansion can have a quantitatively important impact on poverty.

In 1977 the central bank of India, with a view to reducing regional differences in financial development and in income, instituted a rule whereby in order to open a branch in an already banked location a public commercial bank had to open four branches in "unbanked" locations.[15] The authors conclude that the bulk of the very considerable rural bank expansion which followed was the result of this policy.[16] They also report (Burgess and Pande, 2003, 12) that rural poverty reduction was more rapid in financially more developed states both before 1977 and after 1990 (when the program was ended) but that pattern was reversed between those two years. Their statistical analysis of the correlates of regional poverty, including rural bank expansion and a set of other political and policy variables considered to be possible determinants of poverty, implies that it accounts for roughly half of the large drop in rural poverty (from 61 percent in 1967 to 31 percent in 2000). Even if these estimates rather seriously exaggerate the true impact of the banks that impact would still be of great interest to policy-makers.

The rural branch expansion was associated with increases in secondary and tertiary sector output, especially in unregistered or informal manufacturing and services, and with a parallel increase in the share of the rural unskilled labor force found in non-agricultural activities, as

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[13] A recurring problem in the analysis of financial policy options is the difficulty in coming to even crude quantitative assessments of whether given policies affect aggregate growth and poverty outcomes enough to matter.

[14] Analyses of the Bangladeshi microfinance institutions and of Indonesia's BRI are reviewed in Chapter Three below.

[15] In 1969 the fourteen largest Indian commercial banks had been nationalized, which brought them under the direct control of the Indian central bank and into the planning architecture of the country (Balachabndran, 1998).

[16] In 1990 the licensing procedure was frozen and in 1991 repealed. Between 1977 and 1990 branch expansion in unbanked locations accelerated while that in already banked locations fell. After 1990 expansion in previously unbanked locations came to a halt while that in already banked locations increased. Banks cannot close rural branches if they are the only bank serving the location so the rural network has been frozen since 1990.

well as a rise in agricultural male wages and a decrease in the role of the moneylender. The authors judge that without coercion it is unlikely either that much of this expansion would have occurred or that equally effective substitutes for the banks' services would have appeared. Microfinance programs, which have been strongly promoted since the end of branch bank expansion in 1990, seem to have been less successful in reaching backward areas (Burgess and Pande, 2003, 19, citing Ramanchandran and Swaminathan, 2001). The commercial banks offer savings opportunities, which microfinance has tended not to do.

Notwithstanding what appear in retrospect to have been important benefits, this program was ended in 1990 because of very high default rates, even though there seems to be no evidence that these rates were higher among the lower income borrowers; the average during the 1990s for commercial banks was 42 percent, with little variation across borrower groups (Burgess and Pande, 2003, 20). Monitoring was weak across the board and default of large scale loans was often politically condoned. Low interest rates also contributed to high program costs; the average for rural areas was 11 percent, vs. 14 percent for urban areas. Experience of good repayment rates by smaller borrowers in other countries (including Indonesia—see below) suggests that these branches might have been operated in a financially sustainable way, in which case the overall impact would have been very positive indeed, judging by the results presented by Burgess and Pande. Even with the low repayment rates, Burgess and Pande estimate the social benefit cost ratio of the program. To be comparable to Khandker's estimates for the BRAC program in Bangladesh (see Chapter Three).

The results of this Indian experience thus suggest the potential from policy-driven bank expansion into financially underserved areas. If the estimated benefits in terms of poverty reduction are at all close to the mark (further probing would be required on this issue), the key would be to achieve low default rates within such a program. Institutions like BRI and the Grameen Bank (and many others) show that this can be done in a variety of contexts. BRI does not lend primarily to very poor borrowers; the Grameen Bank focuses more on that group.

Public banks with mandates to lend to small farmers or to small non-agricultural firms are in principle another way to increase coverage or inclusiveness of the financial system. Like the Indian experiment just discussed, most such experiments involved severe financial drains arising from the same sorts of problems. A few decades ago it was the norm to have special state-owned banks providing finance to each of these sectors, because the exclusionary formal financial sector was not friendly to them. There were also special state-administered and foreign-financed credit lines targeted specifically to them, with mandatory credit allocations and credit guarantee schemes.

The overall value of the specialized institutions and loan funds created by governments has probably varied a good deal from case to case, according to their level of efficiency and, above all, their default rates. Some groups of firms with poor access to private banks—such as small, new, or non-Chinese (pribumi)-owned SMEs in Indonesia—have rated public sources highly in relative and absolute terms. For some borrowers the lower interest rates on loans from public sector sources may have been an advantage, even when bribes required to get the loans lessened that advantage. But benefits have been scanty for firms for which the time-consuming and cumbersome loan application procedures were costly. And inefficiency and nepotism seem to have plagued a great majority of such public financial institutions.

## The Informal Sector Provides a Form of Inclusiveness

While a more effective formal financial sector is of course desirable per se, it can never satisfy the financial needs of everyone. The informal financial sector clearly fills in part of this vacuum; how well it is able to do so, and the (related) determinants of its size and of the way it interacts with the formal financial sector remain matters of considerable controversy. A common view (for example, Levine, 1997) is that excessive market segmentation—in particular between the formal and informal components, impinges negatively on the poor by excluding smaller businesses from formal financial services and thus impeding their development and employment creation. Formal-informal segmentation has been attributed variously to the following factors:

- Financial repression by governments;
- Uncompetitive behavior by oligopolistic banks; or
- The natural informational asymmetries inherent in lending relationships between borrowers and lenders, especially in low income countries.

The relative importance of these contributing factors to segmentation matters a good deal for policy. There are thus strong disagreements as to both the universal desirability and the best means of reducing such fragmentation in order to improve small firms' access to finance. The "financial repression" school of thought puts much of the blame for segmentation on bad financial policy and expects its damaging effects to diminish significantly when policy is improved. But the issue is complex. In the first place, not everyone accepts that exclusion of some groups of firms from formal finance is all that bad. In developing countries, the capacity of the usually large informal market to fulfill intermediation functions is the big issue. If and where it does score high, the limited coverage of the formal system is of less concern.[17]

Levenson and Besley (1996) point out that in Taiwan the informal sector has played an important role even in the absence of financial liberalization; the underdevelopment of the formal financial market has not been a barrier to Taiwan's remarkable growth. In a typical year, at least one-fifth of all households participate in rotating savings and credit associations (ROSCAS), with participation increasing with income. Many such associations around the world provide funding mainly for consumer durables and would thus not be so much help to small firms needing credit for production purposes. Other types of informal credit do loom large in the borrowing patters of small firms, however (see below).

The conclusion that the informal financial sector can sometimes be reasonably or even quite effective means that policy should be designed with that objective in mind but,

[17] Authors like von Pischke et al. (1983), McLeod (1984), Yotopoulos and Floro (1991), and Besley (1995) have made arguments along these lines.

simultaneously recognizing that greater outreach of formal institutions might be a still better way to aid the creation, survival, and especially the growth of more and healthier small firms. Among the ways the formal component of a financial system may malfunction is a pattern in which the coverage of its capacity to attract savings exceeds that of its capacity to lend. When this is the case an improved performance by the formal financial institutions, by drawing funds away from the informal financial market, may deter the growth of smaller firms which would otherwise be able to access those funds and thereby lower the overall efficiency of resource allocation (van Wijnbergen, 1983; Taylor, 1988; Mosley, 1999).[18]

When it offers high real interest rates (as under tight monetary conditions) it may compete with real investment by some small firms (through the higher payoff to the financial assets it offers) and thereby depress rather than increase such investment (Morisset, 1993).

Thus, the impacts of formal sector financial development on poverty may vary greatly according to the setting in which it takes place: shrinking of the informal sector is likely to be undesirable unless the formal sector is in a position to provide credit to the informal market's current clients. **Still, a well-functioning informal financial sector, while very helpful, cannot substitute for formal financial sector failings, especially as the economy becomes more complex.** Typically, both segments of the informal market (family, friends, etc. and the less informal "curb market" mentioned in Chapter One are important to smaller enterprises and to others less favored by the formal financial system. But they are seldom extensive enough to carry out all or nearly all of the needed resource transfer.

## Credit Can Help SME and Microenterprise Growth and/or Productivity[19]

Credit is commonly judged to have played a significant role in the major SME success story countries. The first country whose SME sector (more specifically the manufacturing component of it, which is referred to as SMI—small and medium industry) was credited with an important contribution to its overall performance was Japan. Shinohara (1968) concluded that "the development of broad-based markets for debt finance and intermediation from a variety of sources in the late 19th and early 20th centuries contributed to the early development of a healthy and sizeable small and medium industry (SMI) sector in Japan." The importance of finance was further confirmed by the facts that the sharp bankruptcy-induced reduction in numbers of banks and non-bank financial institutions in the early 1930s had a devastating effect on SMI Conversely the gradual rebirth of credit markets in the postwar period contributed to the remarkable resilience of SMI in the face of other forces which favored large enterprises such as the country's strategic emphasis on exports, heavy industry and sophisticated technology (Shinohara, 1968, 55).

Korea's very rapid industrial growth over several decades, including that by SMEs since the mid-1970s, has been substantially credit-driven. The resulting high levels of firm debt have

[18] Literature on the "structuralist" critique of the McKinnon and Shaw arguments against financial repression is cited in Bencivenga and Smith (1992).

[19] The impact of microcredit on the performance of microenterprises is reviewed in Chapter Three below.

given the government cause for concern and at times led to attempts to lower them. Relatively to most other LDCs, Korea's SMEs have good access to credit and are rarely dependent on a single source, often having a choice between private and collective sources (Kim and Nugent, 1999, 159).

How important does credit, or external finance more generally, appear to have been in other episodes of fast SME growth? A case of special interest, partly because it took place outside the East Asian miracle setting, is Colombia's SMI boom (average growth of close to 10 percent per year from an already significant base) from the late 1960s through the 1970s.

Cortes et al. (1987, 216) conclude that significant factors in this boom included the increasing availability of capital and foreign exchange, along with the broadening of the market for second-hand machinery and other factors. Over 1968-78, loans outstanding from formal banking institutions to SMI grew at 12 percent per year according to one World Bank compilation (Cortes et al., 218). This pushed the ratio of formal sector loans outstanding to value added from less than 10 percent to closer to 15 percent. The commercial bank component of the loans outstanding rose by just 8.1 percent per year; the gain in the loans/value added ratio came entirely from other sources, especially from the development bank charged with funding small enterprise, the Corporación Financiera Popular.

Evidence from countries that have used specialized financial institutions or special credit lines to reach SMEs appears to support the same general conclusion suggested by the above cases—that credit access significantly affects SME growth at both the firm and the aggregate level. Together with this individual country experience, support for the contribution of formal sector credit to SME development comes from the most important cross-country analysis of that relationship. Nugent and Nabli (1992) find the share of SMEs as a percent of employment in all manufacturing establishments of 10 or more workers to be positively related to the development of the credit market,[20] and negatively to that of the stock market.[21] This result provides support for the reasonable expectation that bank credit is more helpful to SMEs while stock markets are more helpful to large firms.

Finally, Beck et al. (2002, 2003), drawing on the most recent and detailed evidence on these issues, the World Bank's large cross-country data base (the World Business Environment Survey) on the financial and legal and corruption-related constraints to firm growth, report that firm growth is negatively correlated with self-reported financial "constraints," especially in countries with underdeveloped financial systems, and that these constraints are especially binding for small firms. A similar finding is reported for both legal and corruption problems.

[20] Measured as the level of claims of the monetary sector on the private sector to GDP.

[21] The sample of countries includes both developing and developed ones. The coefficients on the variable representing the development of the credit system and the stock market are larger in the LDC sample and more significant (the latter is not significant overall or among DCs).

## C. DETAILS ON WHAT SORT OF FINANCIAL SYSTEM WORKS FOR SMEs

The evidence reviewed above suggests that better access to credit would allow many SMEs to become more efficient and to grow faster. This section addresses how developing country financial systems can improve their performance in this respect.

### 1. Strengthening Formal Financial Sector Capacity

Strengthening formal financial sector capacity to lend to SMEs involves internal improvements, some of them supported by public policy. A formal financial system will achieve this goal better when its institutions carry out the following tasks:

- Have better designed rules to guide lending to SMEs,
- take advantage of useful technologies to fulfill that task,
- develop more SME-specific personal expertise, that is, more people who have enough feel for the context of SMEs to be discerning lenders,
- ensure that those engaged in SME lending have strong incentives to make the activity a success
- broaden the range of financial services they can provide,
- work in a context with positive borrower attitudes to loan repayment, to business improvement, etc.

The dramatically successful performance of the SME sector in Taiwan is especially eloquent in support of the goal of **developing skills in SME lending.** There is a significant share of all bank assets have been owned by institutions specializing in smaller scale savers. Among them they had nearly 25 percent of bank assets. [22] Where the institution lends mainly or exclusively to small firms its incentive to do so efficiently is obvious. When its main business is with larger clients this is much less likely, and tends to pose a larger institutional challenge. Making sure that the needed human skills are built up may be best achieved by the creation of a separate SME (or micro and small firm) lending unit in order to focus on the specific task at hand, provide separate accountability from the other activities of the bank, and guarantee that becoming expert in this area is not a dead end career path within the institution. This was the route pursued with great success by BRI in Indonesia (see Chapter Three) in its micro and small firm lending activities.

On the **importance of a healthy borrower attitude to loan repayment** there is no dispute. Much of Korea's success in the provision of financial support to SMEs is attributed by some observers to strong incentives for SMEs to repay and the resulting low rates of arrears and non-payment. This pattern was also inculcated in micro and small borrowers from the BRI program in Indonesia. In countries like the Philippines, and in Indonesia with respect to credit programs administered by government ministries, repayment rates have been far lower. The result is that SME credit and savings programs are not sustainable.

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[22] Credit cooperative associations had five to six percent of assets in the 1980s. Farmers' and fishermen's associations had a similar amount. The postal savings share skyrocketed from 1.35 percent over 1961-65 to 11 percent in 1986-88 (Chiu, 1992, 129).

The financial chaos of recent years has weakened debtor resolve to repay loans in countries from Colombia (Urrutia and Zarate, 2003) to Mexico to Indonesia (Indonesia Country Case Study) as debt forgiveness is mooted in public discussions or becomes an issue of legal contention. Once borrowers learn that not everyone was expected to pay back it becomes increasingly difficult to get anyone to pay back. The major challenge is to cultivate and maintain a healthy national attitude towards loan repayment, which involves broad social attitudes of relevance well beyond the field of finance. It is pivotal that the state not undercut good business practice in this area, where the fruits of a more gradual building up of positive attitudes can be lost rather quickly. Much of bank prejudice against SME lending comes from the perception that repayment problems will be a headache; when this is demonstrated to be false the private incentive to pursue this market becomes much stronger.

Along with increased bank capacity for and interest in lending to SMEs comes the development of **debt instruments and/or lending procedures that are better suited to the needs of one or both parties**. One example of such advance—the use of adjustable variable interest rates—is credited with the large increase in medium and long term loans as a share of all loans in Taiwan (from 29 percent in 1961-65 to 61.4 percent in 1986-88). From 1979 the locally incorporated commercial banks gradually adopted this financial innovation, previously introduced by branches of foreign banks. It meant that they did not have to assume more interest rate risk in extending longer term loans (Chiu, 1992, 164). There have been many innovations in the effective use of information technology, which can lower the fixed costs of lending, especially important for small loans; for example, modern software allows easy and automatic tracking of loan repayments.

## 2. Who Can Lend Effectively to SMEs?

Virtually all types of banking institutions (for example, large banks, public banks, foreign banks) have the capacity to lend to SME. There has been a conventional wisdom, supported by an extensive U.S.-based literature (see Berger and Udell, 1995), that large, complex institutions are not cut out for this role. Mester (1997), however, argues that **advances in credit scoring methodologies coupled with enhanced computer power and increased data availability could be changing the nature of small business lending and hence rendering it easier for larger institutions**.

The ability of some large developing country banks to operate efficiently in this area is confirmed by experiences like that of BRI in Indonesia, which is both large and public but lends very successfully to both micro and small enterprises. Foreign banks do some lending to medium sized firms (see below). That all categories have shown some potential does not of course mean that all have the same potential, and thus far the evidence suggests that smaller banks do focus more on this clientele.

## 3. Does Inter-bank Competition Improve SME Access?

Increased competition among banks, whether new domestic or international ones, may improve the credit access of SMEs; some positive evidence comes from industrial countries like Canada. A number of observers feel that this process is occurring in various parts of the developing world, for example, Westley (2001, 16) for Latin America. The record in many LDCs has, however, become confusing in recent years as many financial systems have been characterized by a downward rather than an upward trend in the number of banks, in response to financial crisis or the threat of it.

## 4. Public Policy on SME Lending

### *Subsidized interest rates should not be imposed on SME lending institutions*

A weakness characteristic of many repressed financial systems has been very low (or negative) real interest rates to both borrowers and savers. As with lending to microenterprise, that to SMEs has often been hamstrung by the idea that market or above market interest rates were inappropriate for this group of borrowers. But, again as with microenterprise, there is little evidence that below market real interest rates constitute a significant benefit to SME borrowers. SMEs should and do have profitable investment projects which can bear normal interest costs. As always, subsidized rates create an incentive for larger firms to get in on the bonanza and for bank administrators to require bribes for access to low-cost credit, while also lessening the financial viability of the lending institutions. When market rates reach very high levels (in the context of very tight monetary policy, for example) the logic of somehow subsidizing rates paid by SMEs is much greater, since even below market rates can be very high in absolute terms. The difficulty lies in finding a way (if there is one) to do this which does not do more harm than good.

Higher and market interest rates for financial savings also affect SME indirectly. Unrepressed and hence fairly high rates may encourage savings which can then find their way into SME investment, either because the saver is the eventual SME entrepreneur or because with a higher level of savings more credit is available to SMEs. Scitovsky (1986) feels that high rates contributed to a savings boom in Taiwan, which one might deduce helped to fuel the SME-led growth in that country. Cortes et al. (1987), on the other hand, judged that a fall in the real interest rate in Colombia induced some people to shift from financial assets to real ones by creating a firm. Both effects could be general to other countries, in which case the overall impact on the SME sector of high interest rates for savers would depend on which effect was the stronger of the two.

In any case, however, it is important to encourage family savings, especially when these contribute to SME growth. As with lending, this involves the sort of expertise which cuts the transactions costs associated with handling small deposits. It also involves prudential and other regulations to assure depositor protection.

Given good repayment attitudes and bank freedom to charge and pay adequate interest rates, banks can overcome the higher transactions costs of dealing with small clients and can learn how to loan effectively to them. Financial crises sometimes reveal (as in Indonesia recently—see box) better repayment by smaller than by larger firms. Really big financial losses by banks tend to occur when large clients cannot or do not repay, or when corrupt stakeholders are able to make off with assets, at the expense of depositors, other shareholders or the state. In short, the bulk of the financial drains on banks in a number of countries involve not the smaller borrowers or depositors but the larger borrowers and shareholders.

**Small Enterprises Repay Better than Large Ones: Post-Crisis Indonesia**

After the Monetary Crisis of 1998-1999 both private and public sector banks discovered that repayment rates varied inversely with size of loan. Most firms were hit by the often sharp declines in demand and the much higher interest rates and imported input prices. While most corporate loans at BRI and other banks were in default, less than half of SME loans missed even one interest payment. Banks discovered that smaller borrowers overwhelmingly resumed servicing their loans as soon as they could while some corporate borrowers simply defaulted, many paid only a fraction of the principal, or turned over assets to the government bank reconstruction agency that were worth only a fraction of their claimed value. All banks therefore concluded that small and medium enterprises constituted an attractive market and lending to them did expanded, especially by the handful of private banks with prior experience in the SME field and with a branch network that enabled them to reach smaller firms in towns; ironically, most commercial banks found that SME were reluctant to borrow from them at the time because demand for their products was still down and because the Government was also pushing cheap credit to this group through cooperatives and other government credit institutions (see Indonesia Country Case).

**Specialized public financial institutions, special credit lines, and regulations directing banks to allocate certain amounts of credit to SMEs appear to have been useful in some countries and under certain conditions**, but must be designed and implemented with great care and only when the needed for them and their potential role have been clearly identified. Permanent subsidies should not be built into the system by such practices; instead the intent should be to contribute to a learning process and a build-up of capacity on the part of the institutions to carry out SME lending. A judgment on whether the benefit/cost ratio of any particular approach to getting finance to SMEs tends to be high or low depends on the details of the case. Each approach has its weaknesses.

Public financial institutions, including those whose mission was to supply finance to the microenterprise and SME sectors, have come under widespread criticism for ineffectiveness. They typically charge lower interest rates than do their private sector counterparts (at least formally, although sometimes part of the differential is "clawed back" in the form of bribes to bank employees). Many have received large subsidies implying that the average real cost of the credit made available was high even when the real interest rate was low; defaults have been frequent.

Some studies have also indicated or suggested that the borrowers from public banks perform less well (for example, in terms of profit rates, benefit/cost ratios, or some other measure) raising the possibility that those banks screen borrowers less well than private banks.[23] Finally, many public banks have suffered from high transactions costs through overstaffing, political appointments which imply low quality of staff, and a general lack of profit motive.

[23] See Cortes et al. (1987, 130).

Though relatively few in-depth assessments of such institutions have been carried out, the anecdotal and circumstantial evidence of frequent and severe inefficiency is incontestable.

Despite their typical weaknesses, however, public lending institutions can play a useful role under certain conditions. There is a wide range of performance levels in any type of institution, with some public banks, such as Indonesia's Bank Rakyat and its micro-lending and SME lending program, performing better than most private ones. There is also a real possibility that private institutions are usually unwilling or unable to cover as wide a range of potential borrowers as would be socially optimal. By picking the best fruits from the tree, such banks keep profits up and losses down. An institution that lends to less promising candidates as borrowers is likely to suffer higher losses, but may still be contributing to economic growth if enough of the borrowers are substantially helped by the loans they receive. Such a case could be made on the basis of the evidence of SME pribumi exporters in Indonesia (see box). To have meaning, performance comparisons of different types of financial institutions (for example, public and private banks) must take account of differences in clientele.

A feature of public or collective sources of finance that has sometimes played a positive role for SMEs is the lesser vulnerability of these sources of finance to business cycle fluctuations in general and to international interest rate changes in particular. SMEs are inevitably vulnerable to variations in lending policies. Public **sources of finance that have been less volatile in credit volume and interest rates have helped to reduce SME bankruptcy rates during periods of tight money and high interest rates**. This emerged as an especially important factor in the case study of Japanese SMEs reported by Levy et al. (1999) but showed up also in some of the lower-income countries included in that study.

The administrative prerequisites for effective directed credit programs, operating either through special funds available to the retail banks for special groups of clients (like SMEs) or through regulations forcing the banks to allocate a given share of their loans to such client groups, are less demanding than for public financial institutions so it is to be expected that the success rate, at least as measured by profitability of such programs, should exceed that for public institutions per se.

Strong evidence of the impact of SME-directed credit programs on the investment and growth of that sector is sparse because of methodological complexities. One careful analysis, by Eastwood and Kohli (1999) concludes that a directed credit program for Indian manufacturing SMEs over the period 1965-1978 raised the ratio of gross fixed investment to sales by 1.8 percentage points. This ratio's average value rose from a rather low 3.4 percent in 1965 to a fairly high 8.7 percent in 1978; thus about a third of the 5.3 percentage point increase--an economically significant amount, was attributed by these analysts to the directed credit program. It is possible that the effect of such a credit line on very small firms (the sample did not include many) would have been even stronger since their credit needs would have been greater. But it is also possible that they would not have been as successful in using the credit.

In another sophisticated analysis of the impact of directed credit programs Santor uses a unique panel data set for Sri Lanka (for the period 1985-1992) to compare the activities of two groups of firms, one with subsidized loans from a World Bank program then in operation, the other without. He finds that the program led to a relaxation of the credit constraints and higher levels of investment for the former group but does not detect evidence of a positive effect on firm efficiency (Santor, 2002, 132). Whether the positive effects identified in these two studies are general is not known at this time; in any case they confirm that directed credit can have measurable effects on investment of SMEs. A good credit guarantee system is a potentially important part of a strong financial support apparatus for SMEs. Unfortunately the very mixed performance of such systems includes many bad experiences and only a few impressive ones.

The Japanese version worked relatively smoothly, in part because it was primarily operated by local associations which have better information than outsiders on the reliability and credit-worthiness of possible borrowers in their geographic area. A hallmark of successful systems like Korea's is limiting the guarantees to partial coverage of loans so that banks have a strong incentive to be careful both in their credit evaluations and in credit collection. In both these countries default rates were kept to manageable levels, at least prior to the financial crises of the late 1990s.

But most guarantee systems, especially in their early stages, have contained major incentive and other problems. The Colombian and Indonesian systems, for example, produced high rates of loan default, often accompanied by long delays by the guarantee system in compensating the banks making the defaulted loans. As a result, lending institutions became leery of extending credit to SMEs except where strict collateral requirements could be satisfied, more often the case with the larger and better-endowed SMEs (Levy et al., 1999, Chapter Six). In short, guarantee systems are a good idea in principle,

**When Targeted Credit for SME Can Be Useful**

A number of credit programs and financial institutions targeted to small enterprises have been evaluated in India, Indonesia, Korea and Colombia. From their analysis of SME exporters in Korea, Indonesia and Colombia (as well as Japan), Levy et al. (1999) conclude that there is some evidence that, without the interventions undertaken, SMEs in these countries would have been able to obtain considerably less external finance than they actually did. The case studies also show that the access of small and otherwise disadvantaged SMEs to external sources of finance, and especially to bank loans, depends heavily on the degree of development of the financial markets. Among these countries, the financial sector is clearly most developed in Japan, followed by Korea, Colombia and Indonesia. As a symptom of the underdevelopment of Indonesia's financial markets, even relatively large pribumi-owned (indigenous Indonesian) SMEs, which were exporting at the time they were surveyed reported not being able to obtain bank loans until relatively late in their lives. For this reason the relative importance of public sector intervention on behalf of SME finance seems to have been much more important in Indonesia than, for example, in Japan or Korea. In particular, 90 percent of the loans received by sample Indonesian SMEs while they still had fewer than 20 employees were from state banks or official credit lines. Furthermore, 73 percent of the loans proffered by state banks, but only 47 percent of those by private banks, were made to firms with less than 150 workers.

All four of these countries relied heavily on official credits to target investment toward desired sectors and types of firms. In Korea the introduction of the requirement that quite substantial pre-specified minimal shares of new bank credit be allocated to SMEs seems to have had a significant impact. In both Indonesia and Colombia, surprisingly large percentages of disadvantaged sample SMEs reported having received their first loans as part of foreign-financed initiatives directed towards SMEs. Whatever access problems exporting firms had would presumably be more severe in the great majority of SMEs that do not export.

but much attention to the details of design and the practice of implementation is needed to make them work.

## 5. The Informal Financial Sector Can Help

Achieving an adequate outreach to smaller firms and desirable breadth of financial services sometimes implies a significant role for the informal financial sector, especially its "curb market" component, in SME lending. Much small firm funding comes from sources other than banks, starting with the small entrepreneur herself and the so-called Acurb market. Country-level evidence tends to suggest that growth of both family savings and the curb market are positively associated with rapid aggregate SME growth.

For the case of Taiwan, Chiu (1992, 159) claims that the forced savings of SME owners who have to build up resources to meet working and fixed capital needs of their firms constitute a significant share of all savings, as well as looming large in SME funding. In Korea credit from a diverse and well-developed curb market has usually been the main source of private financial support for SMEs (Kim and Nugent, 1999, 151).

It has included a range of sources:

- Rudimentary credit markets based on reputation and family relations but with no tradable assets involved;
- Rotating credit schemes;
- Informal commercial paper markets, operated by chaebol-owned (large conglomerates( finance companies and somewhat regulated by the Bank of Korea;
- The curb market proper, a large scale informal credit market with its own collection agency, brokers and real estate agents; and
- Semi-regulated financial institutions such as mutual savings and loan funds, popular funds and private finance companies (Kim and Nugent, 1999, 151 and 167).

When **public policy has sought to reduce credit access in general, this curb market has been especially important to Korean SMEs**. Colombia's experience during its SME boom period was also characterized by rapid growth of aggregate family savings, fuelled in part by an economic boom. As financial asset returns fell with accelerating inflation, people may have been more inclined to invest in small businesses. An extra-bank credit market also evolved, similarly fuelled by the increase in inflation. **The prevalence of the curb market in some cases of successful SME growth raises the interesting possibility that sometimes SMEs may fare better the higher the share of intermediation carried out in that market**.

**Trade credit** received from suppliers or buyers is another important nonbank source of external funding. In Taiwan (1988) such trade credit amounted to 45 percent of external finance, compared to 31 percent for the formal credit institutions. In Mexico, as of 2000 and after a period of tightly restricted bank credit, such credits accounted for 64 percent of external finance for small manufacturing firms and 54 percent for medium-sized ones. Even large firms got 44 percent of finance that way (Berry and Ruiz, 2002). They accounted for 55 percent of externally financed working capital for a sample of Indonesian SMEs (McLeod, 1984, 24-7). Such figures hint at a very considerable importance of trade credit to SMEs but remain ambiguous since few studies present net trade credit received. For some SMEs net trade credit received is no doubt large while some others are net creditors. The overall impact on the performance of the sector can thus only be guessed at.

Since informal sector and trade credit are arrangements among people or firms based on mutual trust, they tend to lie outside the scope of public policy. A good legal system should help them to work better and some form of regulation may become appropriate when institutions involved in the curb market achieve a certain size and complexity.

## D. Do Stock Markets Contribute to Pro-Poor Growth? The Jury Is Still Out

Given its association with large-scale enterprise, stock market development would seem more likely to influence the pattern of growth in an anti-poor than a pro-poor direction. Thus such benefits as it might have for the poor would come through a positive effect on the growth rate. There has, however, been no strong presumption that such an effect is the norm in developing countries. Given that they stock markets have recently grown rapidly, the issue has taken on much greater significance over the last decade or so.[24]

At a theoretical level, there are some interesting positive arguments, together with a couple of negative ones. Stock market development could produce faster growth if it raised domestic savings, facilitated a greater inflow of foreign savings, or increased the efficiency of investment. Clearly it has induced inflows of foreign capital into a number of countries—though this has often been a mixed blessing, as such flows have been associated with subsequent outward surges and the resulting macroeconomic instability. It could raise domestic savings rates through the attractiveness of equity as a savings instrument for families or corporations. But it could also lower the savings rate through the Pigou effect on wealth (see footnote 2 above).

The stock market could raise the efficiency of investment if it is a better allocator of funds among activities than are alternative financial institutions. The opposite might happen if it channels funds preferentially to large firms in a situation where SMEs would use the resources better. Bencivenga, Smith and Starr (1996) put the positive case, arguing that equity markets allow savers to acquire a flexible asset (equity) which can be sold quickly and cheaply if they need liquidity or want to alter their portfolios. Equity markets also give companies permanent access to capital and thereby facilitate longer-term and more profitable investments. By making investment less risky and more profitable, a well-functioning stock market could lead to more savings.

[24] Demirguii-Kunt and Levine (1996a) note that portfolio flows of equity investment to emerging markets soared from $0.1 billion in 1985 to $39 billion in 1995. Even after the financial crises of the late 1990s, they have remained far above the mid-1980s level.

Empirical analysis of this matter is recent and the conclusions are hence likely to be subject to continuing revision. It is almost certain that some elements of financial development contribute to economic growth, and it is reasonable to accept that overall financial development (composed of those beneficial elements and others) usually has positive effects on growth.The question is whether stock market development is one of the positive elements.[25]

Recent studies (Levine, 2002, 2003; Levine and Beck, 2002) report that it is the overall provision of financial services that spurs growth and that financial structure (i.e. the relative importance of banks versus stock and bond markets) has no discernible impact. Arestis et al. (2004, 12) dispute this latter claim, on the grounds that it is based on inappropriate methodology (reliance on cross-country analysis without being able to take adequate account of cross-country heterogeneity) and conclude that financial structure does matter and that market-based financial systems appear more conducive to growth in four of six countries studied.

Meanwhile, as noted above, there is cross-country evidence that, at least within the manufacturing sector, stock market development is relatively more conducive to growth of large firms than of SMEs, a plausible expectation since SMEs make so little use of stock markets.[26] This conclusion does not imply directly that stock market development slows SME growth, since the statistical results relate only to relative inducement to larger firms vs. SMEs. Nonetheless, the plausible hypothesis that stock market development will constitute an impediment to SME growth must be taken seriously until demonstrated to the contrary. This is especially true if there are not simultaneous and comparable improvements in the financing system for those SMEs such that the stock market does not wind up diverting savings from investment in SME.

If it turns out that stock market development is generally conducive to economic growth, then even if it is mildly discouraging to SME development its impact on poverty would at worst be ambiguous. If or where such a growth effect proves ultimately to be an illusion, then the implications of stock market growth for poverty could be worrisome, especially in the short to medium run when so much of the responsibility for employment creation must rest with smaller firms.Given that stock markets are one of the later-evolving components of the financial system, becoming important only in the middle stages of economic development, it is quite probable that their presence is more likely to provide net benefits in middle income than in poor countries. They may in that sense be parallel to a capital-intensive technology which might be appropriate in Mexico but not in India.

The complexity of the issue precludes any confident conclusion at this time. Relevant considerations (in general or at the country level) include:

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[25] Demirguii-Kunt and Levine (1996b) find that stock market development is a good predictor of future economic growth, with the implication that it contributes to that growth.

[26] Nugent and Nabli (1992, 1492) note that where equity markets are highly developed a "venture capital" component gets going and does help some small firms. Still, "virtually everywhere the finance available from equity markets goes almost exclusively to" large enterprises.

i) How stock market development affects the evolution of the rest of the financial system. Comparisons across developing countries confirm that those with better-developed stock markets also have better developed banks and non-bank financial intermediaries such as finance companies, mutual funds, investment companies and pension funds (Demirguii-Kunt and Levine, 1996a). Yet there are significant differences in the relative development of the various services. The most positive reading of the former (unsurprising) pattern might be that stock market development induces (crowds in) the development of other financial instruments and is thus responsible for a bigger increase in total net savings than the increase in savings flowing into the stock market itself. But the positive cross-country correlation among types of financial services does not preclude the possibility that policy steps to favor stock markets would cut the flow of funds through other financial mechanisms. This issue is of special importance to the financing of SMEs where they have little direct or indirect access to funds raised on stock markets. Direct access is known to be small in most countries. But indirect access, for example through receipt of trade credit from larger firms which do have that access, could be substantial. This has not to our knowledge been quantified.

ii) The degree of complementarity versus competitiveness between larger firms and smaller ones. Were complementarity the norm, it would not matter much who had the best access to financial resources; the high level of mutual interest would assure an adequate flow of finance on through to the partners. But large commercial firms are often accused of stifling the productive potential of small suppliers through their oligopoly or monopoly pricing. Large firms sometimes provide trade credit for small ones but sometimes demand that the small firms render that service to them. When small suppliers are hit by macroeconomic or financial crises, large firms sometimes buy equity in them, a process which can lead to industrial concentration.

In short, it is a very complicated matter to understand the implications for SMEs (and for their contribution to poverty reduction) of any phenomenon (like stock market development) whose main direct benefits accrue to larger firms. The extremely limited understanding of the full interface between larger and smaller firms hampers us greatly in that task.

## E. The Effects to Domestic Financial Liberalization

The impact of domestic (as well as external) financial liberalization on pro-poor growth depends mainly on how these changes influence the allocation of resources towards labor-intensive activities, defined both by industry and by firm size, along with the impacts on aggregate savings (which affect the growth rate) and (of special relevance) the savings of the poor themselves and others who through their enterprises create a large number of jobs per unit of savings (e.g. smaller and /or labor-intensive firms).

Traditional financial systems in developing countries involved a high degree of regulation of banks and other institutions, usually including ceilings on the interest rates which could be charged to borrowers, in the expectation that low interest rates would encourage investment (though they would also indirectly limit the interest rates which could be paid to savers and might thus discourage savings); fairly tight restrictions on how institutions could invest; controls on international financial transactions; and a considerable direct pubic sector involvement in the form of state banks of various sorts. This paradigm accepted that the private financial sector suffers from serious imperfections and that on their own private banks would not direct funds in a socially optimal way. The general direction of financial reforms of the last couple of decades has been to lift the financial repression implicit in the cited restrictions on financial institutions and to move closer to a free market allocation of funds. Financial systems have become more open to foreign investment. The role of public financial institutions, while still substantial in many countries, is on the wane. Liberalization has tended to reduce the special programs designed to support the needs of the SME sector and to eliminate such special conditions as subsidized interest rates; much of the logic of liberalization is the idea that financial repression results in misallocation of credit and unequal access to it.

The critics of financial repression argued that it not only lowered savings rates, by facing savers with low or negative real interest rates, but also increased dualism (and with it income inequality) and lowered allocative efficiency and hence the growth rate. With heavy regulation by central banks and with interest rates set well below equilibrium, the limited credit was rationed in favor of larger, well-connected and collateral-endowed firms, leaving SMEs largely without external finance (McKinnon 1973, Shaw, 1973, Fry, 1995). Under inflationary conditions (especially prevalent in Latin America) the interest ceilings tended to produce negative real interest rates and thus made borrowing very attractive to those favored enough to be able to do it. Such ceilings were also an invitation to the banks to opt for the least risky options, to accept bribes from borrowers to get access to the cheap funds, and to channel the scarce resources to associated non-financial enterprise, to friends, and so on.

Some of the special credit lines favored better-off groups.[27] Starting from this base, deregulation and perhaps privatization, by giving market forces a larger role in determining interest rates and credit allocation, could lead to a larger share going to SMEs. This might be true even if previous regulations required certain specified percentages of the available credit to be allocated to SMEs, since it was widely believed by critics that these regulations were substantially evaded by the banks. Increased competition among banks and other financial institutions could increase supplier interest in dealing with SMEs. In principle, therefore, liberalization of the domestic financial system could bring positive impacts on both growth and income distribution through a more equal access to credit as a result of the removal of restrictions on interest rates and other elements of financial repression and through more equal access to attractive savings instruments.[28]

[27] Cho (1988) argues that directed, subsidized credit programs in Korea favored a few large companies, transferring resources from small investors to these large borrowers; this was part of a quite deliberate espousal of heavy and chemical industries. The larger firms were also expected to be more competitive in the international market and were considered essential to the Korean strategy of export-led growth. Taiwan, in contrast, limited the scope of its selected credit programs while maintaining positive interest rates. Its credit distribution was accordingly much more even among firms of different sizes than that in Korea. The smaller firms were competitive in some lines of exports, but not in others. Tybout (1983) concluded that selective credit favored the large firms in Colombia. Sines (1979) claimed on the basis of his study of food processing in Venezuela that this sort of discrimination lowered capital intensity in small firms and also lowered the total factor productivity (TFP) for firms denied access to institutional credit.

[28] Among studies reaching this conclusion are Jaramillo et al. (1996) and Siregar (1995).

Although it was not always explicit, the thinking of this school relied on the idea that private financial markets would work relatively well, based on competition. Criticisms of the views of the "financial repression school" have come from several directions. The "information economics school" (Stiglitz and Weiss, 1981, Stiglitz, 1994) argues that relatively low interest rates are sometimes simply the result of internal, profit-maximizing decisions of the banks themselves; hence it is simplistic to expect the interest rate (the price of borrowed funds) to bring about an efficient allocation of resources in this market.[29]

Other criticisms focused on the inherently oligopolistic character of the sector and its strong linkages to non-financial members of broad economic conglomerates, implying that this feature would prevent it from providing the level playing field among borrowers on which the critics of financial repression counted, and the associated efficient allocation of capital this level playing field was to provide. It is generally accepted that competition may have to be limited in this sector because large institutions are likely to be more stable and to run less risk of bankruptcy under negative shocks than small ones.

The disadvantages of oligopoly as a market structure (implicit in the existence of a few large and dominant financial institutions) must then be accepted as the price of financial and overall economic stability. Diaz-Alejandro (1985) underlined the risk of financial crisis inherent in relatively unregulated financial markets, a risk amply borne out in the many crises of the last couple of decades. The extent to which financial repression has contributed to financial market segmentation (vis-à-vis the other factors noted above) bears especially on the extent to which the financial reforms of the last couple of decades will improve formal financial sector provision of services to very small borrowers and savers, i.e. to those found in the informal or microenterprise sector.

We return to the evolution of and issues surrounding microfinance in Chapter Three below. For SMEs, however, it is primarily the performance of the formal financial institutions—especially the commercial banks, which matter though the informal "curb" market is often also important to these firms.

Meanwhile, the efficiency and distribution impacts of financial liberalization through its effects on the informal financial sector could vary greatly, depending on the structure of the latter and on the nature of its interactions with the formal financial sector. In Korea, for example, the main problem with financial repression from the SME point of view seems to have been its negative impact on the more competitive and less regulated curb market on which the SMEs had come to depend.[30]

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[29] Charging very high interest rates may have the effect of screening out good borrowers and leaving those who overestimate the payoff to their planned investments and/or put low weight on repaying their loans. Such negative screening would lower bank profits.

[30] Whereas in some countries repression did not affect this market much, or even let it flourish, in Korea it was regulated enough to have its size substantially curtailed.

The evidence on the high and rising role of supplier credits for small firms in Mexico in the wake of the mid-1990s financial crisis following on the opening of the capital account likewise highlights the importance of a better understanding of where bank credit fits in the bigger financing picture for small firms. Until empirical studies clarify such relationships, both positive and negative hypotheses on the impact of internal financial liberalization deserve some credence.

## A Judgment Thus Far

Given our present (limited) understanding, financial liberalization as it has generally proceeded thus far is best thought of as the shift from one quite imperfect system to another which may also be seriously defective, unless carefully refined to minimize its weaknesses. As with the impacts of financial sector development on growth, it also appears that the effects of financial liberalization could vary widely by country, according to how the processes are undertaken and on how the previous system was structured and regulated.[31]

Even apart from the obvious urgency of making the new systems less vulnerable to financial crisis, benefits may be delayed by the need for complementary improvements in regulatory systems, the legal structures, audit procedures, accounting systems, and bank practices, which could in some cases even be viewed as pre-conditions for effective liberalization.32 With respect to bank practices, one effect of financial repression was underinvestment by developing country banks in information capital (Caprio et al., 1994). Other economic reforms such as trade liberalization may have rendered uneconomic part of such limited information capital as did exist (Griffith-Jones, 1998).

In such a context it is unrealistic to expect, as some proponents of liberalization have claimed, that simply letting the real interest rate rise to its natural (market) level will solve the credit access problem of smaller firms (Cook, 2000, 24).[33] Where liberalization is implemented carelessly, without due regard for the need to counteract the inherent instability of financial systems, its overall effects can clearly be negative. But it does seem likely that some movement away from the old financial repression model was desirable, especially in those cases where inefficiency and corruption accentuated its weaknesses.

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31 Cho (1988) looked at the variance of borrowing costs between firms as a test of the effect of the Korean reforms on allocative efficiency, and reported that this variance fell after the reforms. This contrasted with the outcome reported in Turkey, where an important mechanism contributing to the different outcome was distress borrowing, which was also observed in Chile after the reforms of the 1970s. In both of the latter cases macroeconomic inconsistencies led to high interest rates, falling profits and firms borrowing mainly to forestall bankruptcy. This phenomenon suggests that one may have to wait some considerable time after the transition period during which they occur to get a good test of the longer-run impact of the reforms.

32 In a very useful review of issues, Gibson and Tsakalotos (1993) make this point.

33 Such theorists also failed to predict or duly take account of the heights which real interest rates would reach under very tight monetary policy. To believe that such market equilibrium rates (if they were interpreted as such) would not squeeze out nearly all small firms would have been very unrealistic. But since interest rate ceilings are unlikely to prevent such exclusion, the main policy conclusion may be that it is very important to avoid the macroeconomic conditions which push policy makers to letting real interest rates get this high.

A tentative judgment would be that:

- Forcing real interest rates to very low or negative levels is indefensible; thus this element of the reforms was good. Whether a high upper ceiling on rates might be appropriate under certain circumstances remains debatable.

- Encouraging bank competition is desirable, as long as it does not get to the point of endangering the stability of financial institutions or the system as a whole.

- Special credit lines, or other inducements to banks to lend to SMEs or other selected groups of borrowers may make sense when well designed and implemented.

Reforms in one or both of the first two areas may particularly benefit smaller borrowers. Thus in Indonesia liberalization plus the successful example of BRI that small loans could be profitable led to a remarkable growth in SME lending by some private banks. Overall, however, the empirical evidence on differential impacts of domestic financial liberalization by firm size remains cloudy. Though studies on Chile and Indonesia provide grounds for optimism that it has positive effects on credit access of smaller firms, others (for example, in Ecuador, probably Turkey) do not. There has been little analysis of the impact on credit allocation by industry to provide clues as to whether the credit access of labor-intensive activities tends to improve. The same goes for the impact of liberalization on savings, either at the aggregate level or for the specific groups noted above. The reforms may have typically overshot in their removal of directed credit lines.

## F. Integration with the International Capital Market

Major effects of international financial integration on developing countries come from the following:

- The resulting (net) foreign financial investment, the entry of large foreign banks in the domestic financial structure, and the increased access of domestic non-financial enterprises to the international capital market; and

- The unstable capital flows, which periodically cause currency overvaluation and sometimes financial crisis and devaluation.

The final impact on poverty and pro-poor growth depends on the net increase in capital brought to the economy (presumably beneficial); the effects on the internal efficiency of financial institutions, via technological transfer, for example (likely positive also, whether through improvements brought by foreign banks and copied by domestic ones, or simply the result of increased competition); and the impact on the allocation of resources across types and sizes of firms, which could be either positive or negative.

The main potential allocative benefit might arise when large foreign institutions take over much of the market made up of large local and foreign clients and the national institutions are induced to shift their attention to the previously underserved client groups like smaller establishments. If the liberalization leads to improved internal efficiency in financial enterprises and the financial sector as a whole, it is also arguable that this should redound especially to the benefit of smaller firms since the banks face higher transactions costs in dealing with such firms. A lower marginal cost should in principle shift some categories of small firms from the unprofitable to the profitable category for the banks.[34]

Less optimistic views focus on two concerns:

i) That foreign institutions may partially crowd national ones out of some markets without pushing them into previously underserved markets.[35] In a worst-case scenario the arrival of foreign banks undercuts the viability of local banks, even ones which are quite efficient, simply because the local banks cannot provide the same apparent assurance of safety to depositors.[36] Thus the process of transition may erode the capacity of the previous national financial institutions without putting anything superior or even as good in their place.

ii) That larger, better placed non-financial firms will be the beneficiaries of the financial opening and the gap between their financing conditions and those of the less favored will widen, placing these latter at a competitive disadvantage (Hawkins, 2000). The financing cost differential will be especially wide when a struggle to achieve monetary-fiscal constraint in order to avoid inflation and continuous devaluation leads to high real interest rates. Those rates bite for enterprises which must borrow locally but not for those with international access.

International financial integration may thus seem more likely to have negative impacts on smaller firms than would domestic liberalization, unless inter-firm linkages are strong enough to transfer some of the benefits of low-cost international finance to the smaller firms. This latter possibility thus also becomes a key area deserving research attention.

As with domestic financial liberalization, the analysis of the effects of increased integration with international financial markets is just beginning. Clarke et al. (2002) reveal that, in several Latin American countries (Argentina, Chile, and Peru) both largeness and

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[34] Given the number of factors which work against wide access to credit for smaller enterprises, one could not realistically expect that liberalization alone would end the financing difficulties of these firms or make their access fully equal to that of larger firms. Steel (1994) notes that the impediments to lending to small firms do not just go away. For example, constraints remained serious in Ghana in the wake of major changes (Steel and Webster, 1992).

[35] The outcome of the competition between foreign and domestic and between larger and smaller institutions will be related not only to the different markets they serve but also to any changes in their ability to vie for savings. Thus SME borrowers could be helped (hurt) either by a greater (lesser) interest from some intermediaries in serving them than before or by a rising (falling) capacity of such interested institutions in accessing financial resources themselves.

[36] In Paraguay, for example, loans shifted rapidly to large foreign banks when financial crisis hit in the mid-1990s (Insfran, 1999).

foreignness are associated with lower shares of lending going to SMEs; while the differences are significant, they are however not enormous (averages across the three countries are shown in Table 2).

Meanwhile, a study by Clarke et al. (2003)[37] suggests that all size groups, including small and medium-firms, have better credit access where foreign bank presence is higher. But the authors note that, due to methodological complexities, this study "is closer to the first rather than the last word on the impact of foreign bank participation on access to credit in developing countries" (ibid, 25).

**Table 2: Share of Lending Going to SMEs, by Bank Size and Type**

| Bank Type | Share of Lending to SMEs |
|---|---|
| all domestic banks | 26.4 |
| all foreign banks | 20.6 |
| large domestic banks | 17.3 |
| large foreign banks | 14.8 |
| small domestic banks | 27.2 |
| small foreign banks | 21.4 |

Source: Clarke et al., 2002, Table 1, p. 24

The **most obvious downside of international financial liberalization is that it has contributed systematically to financial crisis in developing countries**. Of 34 economies undertaking suggesting liberalization between the beginning of the 1970s and mid-1997, almost all experienced some form of systemic financial crisis (Williamson and Mahar, 1998). Better **supervision and regulation was associated with less severe crises,** suggesting that reforms in these areas should lower the frequency of future crises. The stability of some financial systems may well be greater if and when foreign banks have essentially taken them over, since they can draw on large pools of resources and can avoid bankruptcy through averaging. It may also be that they are less likely to engage in corruption and theft of resources than their national counterparts.

It appears that smaller non-financial firms are more vulnerable to financial crises and credit tightening than is larger ones. Domac et al. (1999) report **evidence from East Asia of the disproportionate damage to the SMEs during the credit crunch, in the form of a stricter contraction of bank loans, a sharper drop in production, and an increasing number of bankruptcies compared to large corporations**. Thus, whatever its eventual benefits, financial liberalization has often had severe short term costs for SMEs.

## G. Trade Liberalization and SME Finance

The possible impacts of financial liberalization on the credit access and conditions of SMEs have been much discussed. Meanwhile, trade reform may have significant implications for

[37] The study combines responses from a 1999 survey of about 3,000 firms in 36 developing countries with data on the degree of foreign bank presence in the countries.

the credit needs of SMEs. Prior to Mexico's trade reform, its firms (particularly those producing importables) were accustomed to a protection-based pricing system that allowed them a profit margin well above international standards, under which they could finance their business mainly through cash flows. Accordingly, financial credit to the private sector was as low as 28 percent of GDP in 1980 (Berry and Ruiz, 2003). Trade reform places domestic import-competing firms under greater competitive pressure and is likely to decrease their ability to finance investment from profits while increasing their need for financial reserves against possible shocks.

For investment of such firms not to suffer from the trade reform, alternative sources must come into play. In Mexico the regular credit institutions were unable to meet the needs; to the extent that alternative sources of funding were found, it was through trade credit. As the shortage of bank financing forces the search for alternative sources of funds, firms try to expand their linkages with other firms, and stockholders from large firms acquire medium and small firms shares, a concentration process typical also of macroeconomic crises.[38]

[38] The role of lack of credit to SMEs as a source of industrial concentration through its contributing to such buy-ups has not, to our knowledge, been the subject of quantitative analysis.

# CHAPTER THREE
# FINANCING MICROENTERPRISE

Microenterprises are the group of firms in developing countries whose credit access has clearly improved over the last two decades. They have been increasingly served by new microfinance systems, some operated by NGOs, some by regular financial institutions. In the course of the microfinance boom it has been confirmed that many financial institutions can provide small loans at much lower cost that most observers had earlier predicted. Repayment rates can be much higher than had been commonly expected, and interest rates do not need to be (in fact should not be) concessional for these favorable outcomes to emerge.

Achieving such success is by no means easy, but a set of new models for assisting very small enterprises has emerged. The modus operandi of such microcredit[39] purveyors differs significantly from the traditional practices of commercial banks in a variety of ways that generally reduce costs and shift the burden of risk from use of collateral to other techniques. Coverage varies widely from country to country. Commercial banks which adopt similar innovative practices have been moving rapidly into this market in some countries.

Ongoing discussions about microfinance fall mainly into four categories:

i) The need for financial sustainability and just what that term means;

ii) the net social payoff to microcredit, both for the poor and for the economy as a whole;[40]

iii) who the beneficiaries are, in particular whether the poor get a significant share of those benefits and whether women benefit as much as their presence among borrowers might suggest; and

iv) how to do it better—new types of institutions have entered the game over the last decade or so, new products are being introduced, more is being learned about what borrowers need, and provision is being streamlined in various ways.

Nearly all of the discussion among practitioners falls in this last category.

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[39] The term "microcredit" is used to refer to a small loan. Microcredit institutions are those which specialize in provision of such credit. Microfinance institutions are those which not only provide microcredit but also other services (like deposit facilities) to individuals dealing in small amounts of money.

[40] Critics argue that such credit often helps the recipients to capture market share from their competitors, but that it has little impact on the total output and income of microenterprises taken as a group due to the price inelasticity of the demand for the goods and services produced. One implication would be that the payoff even to sustainable microfinance provision might vary considerably according to the macroeconomic setting; that is, according to the strength of other sources of income growth.

## A. TYPES OF MICROFINANCE BENEFITS

1. The original expectation (and still common perception) was that the benefits from microcredit would take the form of **higher output and hence incomes for the borrowers**. And, indeed, most impact studies do conclude that microfinance generates substantial income gains for the borrowers, including those below the poverty line, with the gains typically increasing over time as additional, larger loans are extended to them, but eventually leveling off as the potential of the business is increasingly realized (Sebstad and Chen, 1996, cited by Westley, 2001, 8).

   Serious evaluations compare income changes of borrowers with those of non-borrowers; Hulme and Mosley (1996, 88) report that in all thirteen of the programs they reviewed the average incomes of the borrower families rose faster than families in the control group and that growth of productive assets was noticeably faster in the former than in the latter. Some borrowers, perhaps inevitably, are left worse off. The authors distinguish investments that raise productive capacity by loosening a liquidity constraint (for example, by raising the level of inventories) and others which involve a technological improvement (for example, introduction of a better machine). As many as a third of borrowers in some programs had adopted a new technology; this was more frequent among those who had received more loans.[41]

2. A significant minority of microloan borrowers use at least a portion of their credit for non-business purposes (Sebstad and Cohen, 2000). Of particular interest is the use to cope with shocks and economic stress events via **a consumption smoothing**.[42] This can both contribute to future income of the family, by helping to avoid loss of productive assets now, as well as providing a cushion to prevent a crisis of welfare. Although not what some early exponents of microcredit had anticipated, such uses are no longer controversial *per se*. In fact, they are often linked closely to investments that raise productive capacity.

3. Although only a very small share of microenterprise units tend to **graduate to the small and medium size range**, the numerical preponderance of the former means that in some countries such graduates appear to constitute a major source of growth in the SME sector. A specific challenge then becomes making sure that this size threshold does not constitute a barrier to many firms because they cannot shift from one lender to another (for example, from microfinance to commercial bank). Notwithstanding the importance of these dynamic firms in some cases, the great majority of microenterprises are household based, like women's businesses that borrow small amounts, never expect or plan to grow past a certain point, and accordingly only want to borrow as much as they can handle. An ideal microfinance system deals effectively both with this majority group and with the minority which have serious growth potential.

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[41] See below for comparable figures from the BRI microcredit program in Indonesia.

[42] Papanek reports indicate that as many as half of all MSME loans by BRI and other banks in Indonesia go to fund housing and consumer durables.

4. A fourth but potentially key contribution of microfinance systems is the **improvement of savings options to poor people**. The traditional informal financial market provided useful savings mechanisms to some people, e.g. through savings groups of various types. But the limited range of such institutions, together with the evidence that many savers are frequently willing to take negative real interest rates in order to buy security (Bixby, 2000), the striking savings rates achieved by low-income households when a good investment opportunity arises, and the impressive levels of deposits received by such microfinance programs as BRI (Indonesia), the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand and others, suggest that there is important untapped potential in this direction. Although most traditional NGO-type MFIs do not take savings, some have been venturing into this terrain. There is considerable business logic to linking the savings and borrowing functions, when the intermediary is large enough and strong enough.

5. **Overall (general equilibrium) impacts on wages and employment of the poor**. The self-employed and employees in microenterprises are part of the (mainly) unskilled labor supply in the country. When microfinance raises the productivity and incomes of enough workers, thereby raising the "reservation wages" of these people, this has the effect of tightening up the labor market and pushing wages up for others who do not borrow from the microfinance institutions. Depending on the parameters of the demand and supply curves for such labor, this beneficial impact can be greater than the direct ones of additional employment generated by microcredit borrowers.

   In settings where there is considerable surplus labor, taking the form of disguised or open unemployment, the initial increase in income brought by the microcredit (or by the increased savings of the poor, due to better savings facilities) can lead to a multiplier effect as the income increase is used to purchase local products. In cases like Bangladesh where the reach of microfinance has been quite large (see below) the sum of these two benefits could be substantial. No attempts have yet been made to quantify it, to the best of my knowledge.[43]

## B. The Criteria of Microfinance Success

The success of a microfinance program can be judged partially by such institution-level indicators as repayment ratios, arrears, and profit rates. A full evaluation, however, also requires evidence on the final impacts of the program on the borrowers and on anyone else who may be affected. The following are elements of such a measure:

[43] The increase in income to other workers due to the generalized wage increase has a partially offsetting loss to those who hire the workers in question, but they are on average less poor than the workers. The multiplier effects on local output through the spending of wage increases, in contrast, have no offsetting loss to someone else since they are based on the use of otherwise surplus labor.

i) Benefits to the borrowers from income increases (related to investment undertaken, etc.);

ii) income benefits or losses to nonborrowers; losses may occur to microenterprises which compete with borrowers and lose market share (see below); benefits may accrue to people living in a local economy which is energized by the increased activity facilitated initially by micro-credit (i.e. multiplier-type effects);

iii) borrower benefits from consumption smoothing or other non-income type benefits;

iv) benefits from the graduation and subsequent growth of microenterprises assisted by credit provision (this could be treated as part of (i) but is separated out here); some of these benefits may accrue to others than the firm itself;

v) profits or losses of the microfinance institution, measured against the opportunity costs of capital. This component is thus positive only when profits exceed those which the capital would have earned in its alternative use.

vi) Indirect benefits resulting from the generalized wage increase (if any) resulting form the increased incomes of those working in the affected microenterprises and from the multiplier effects on local output as those increases in income are spent.

In principle the sum of the numbers falling in the first five of these categories would provide a good measure of the performance of a microfinance institution. The sixth category involves benefits which are the combined result of all microfinance institutions and are thus harder to allocate to the activities of each one. In fact, several of the components are hard to measure and so must be guessed at.

It should be noted that the overall assessment could be positive even if the institution were suffering financial losses; this depends on how large the first four items (taken together) are. In that case financial sustainability may be a greater challenge to the institution than its ability to provide economic benefits to society.

Note also that a lower level of overall net benefits might well be considered acceptable for a microfinance institution than for some other business because the bulk of its benefits are presumably accruing to lower-income people; this distributive aspect could be taken into account by placing a higher valuation on a dollar of benefits accruing to a poor person.

Finally, it is quite possible (probable) that the net benefits or losses from an institution's activities will change over time, as when it learns how to perform better with experience. In that case it is essential to judge success by an appropriate average of performance over different points of time, by taking the present value of the future net benefit stream.

## C. The Achievements of Microfinance

Many microcredit programs appear to have been relatively successful in achieving the objective of raising the incomes of borrowers through capital investment and technological improvements and providing a degree of protection against shocks. Progress on savings promotion has been less general (it is a more recent goal than the others) but the startling success in Indonesia and several other countries shows what can be achieved (see below).

The limited evidence on success in fostering high growth firms is mixed, as again might be expected given that this too was not one of the original central goals of the programs. Few studies are complete enough to take account of indirect effects and thus give some feel for the social rate of return to the resources invested in microfinance programs. Those few studies are, like those of the Burgess and Pande (2003) analysis of rural banking in India, reassuring. Even modest average rates of return could be considered a success, where the beneficiaries are mainly poor or near-poor families or the program is still in a learning process.

For microfinance, Khandker' (1998) very thorough analysis of the main Bangladeshi MFIs—the Grameen Bank, BRAC, and RD-12, sets the standard in terms of methodology. In addition to its analysis of borrower benefits, the study attempts to take account of the impact on non-borrowers by studying village-level program impacts, by comparing overall outcomes between program and nonprogram villages; any negative effects on non-borrowers in program villages should in principle be reflected in the overall outcomes for those villages. The conclusions are encouraging.

The following are key findings at the individual borrower level:

i) The marginal return to borrowing (increase in consumption per taka for loans outstanding) was 0.18 for women borrowers and 0.11 for men in the Grameen case, similar for BRAC but much lower for two other banks for which this estimate was made (Khandker, 1998, 136).

ii) The ratio of cost (in the form of net subsidy) to benefit (in the form of increased consumption) was a low 0.91 for female and 1.48 for male borrowers from the Grameen Bank; these figures were much higher for BRAC because the ratio of subsidy to average loans outstanding was much higher (average size of loans was much lower).[44]

[44] The figure of 0.91 for female borrowers from the Grameen Bank means that a subsidy of 0.91 taka corresponds to the loan size which has the effect of raising consumption by one taka. Such a resource use would be desirable even if the beneficiaries were not poor people. When the cost/benefit ratio exceeds one, such use of resources would not be desirable in the absence of a poverty-reduction objective. The estimates are subject to various possible biases; among those which may lead to an understatement of the benefits are the fact that only consumption effects are included even though the loans presumably have also a positive effect on investment and education, and the fact that the calculation is based on the marginal effect on consumption of another taka in loans outstanding rather than on the average effect, which would presumably be larger (Khandker, 1998, 135, 144). There is also a possibility, however, that costs have been underestimated for some of the programs.

iii) Borrowing also raised net worth (here the impact was much greater for men than for women) and children's schooling (more for boys than for girls). Women's credit had a large impact on two of three measures of child nutrition whereas men's generally did not (Kandker, 1998, 47-49).

iv) Slightly more than a third of Grameen Bank members used their loans as a source of start-up capital for rural nonfarm activities (Khandker, 1998, 78), a high figure in relation to the typical shares of small start-ups in developing countries which can take advantage of such loans from any financial institution.

The all-important village level statistical analysis found that, taking account of other determinants of poverty levels, each of the three microcredit programs reduced poverty ; in Grameen Bank villages for example this effect was about 12 percentage points. By comparison, the poverty reduction impact calculated on the basis of the estimated consumption gains among individual program participants was 21 percent; Khandker (1998, 57-8) suggests that the difference between the 12 percent and the 21 percent is related to a redistribution impact within the village; thus, although program borrowers benefited by an average of 21 percent, some nonborrowers have lost such that the average resident's gain was just 12 percent. Interpreted this way, although the estimate of gains among participants substantially overstates net benefits to everyone, the villages as a whole still gained very considerably.[45]

Accepting that participants gain by an average of 21 percent and non-participants do not lose anything implies an impact large enough to raise about 5 percent of participating households out of poverty each year or about one percent of Bangladesh's population; accepting that losses to non-participants bring the average net gain down to 12 percent implies a poverty-reducing effect a little over half as great. Either way, though it does not by itself constitute the answer to Bangladesh's poverty problems,[46] the impact of microfinance is significant, especially if maintained over time.

Though further expansion is no doubt possible, it has its limits since some families would not be eligible to borrow and others would not be in a position to benefit anyway. Keeping the overall returns to additional lending high would also require complementary investments in infrastructure, education and training, health and other needs. In any case, Khandker's analysis points to very considerable net benefits from microcredit, effects which imply that, when operated on a scale and with the efficiency levels of the main purveyors in Bangladesh, microfinance is one of the main policy instruments to be used in addressing the poverty challenge.

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[45] It is possible that because microcredit tends to support the same activities in the different villages, and that there is some competition among villages, that the overall net benefits to the country might still be overstated by the village income effects reported here.

[46] Given the poverty line used here, 63 percent of Bangladesh's rural population was in poverty in 1991/91. Approximately half of the poor population was eligible to participate in microcredit programs and of these roughly 45 percent were participating; thus, microcredit programs effectively benefit roughly 20 percent of the total population (Khandker, 1998, 60).

Such uncertainty as remains with respect to the payoffs from microcredit programs, and hence their priority within the pro-poor policy package, relates to the fact that the true payoffs to programs judged successful by the simpler methodologies typically used (e.g. in the studies reviewed by Hulme and Mosley) may in fact be either considerably higher or considerably lower than those approaches indicate;[47] possibly some are much better than they appear by these evaluations to be and others much less good. An important task in future will be to distinguish which programs fall in which category. The available indicators of success and the evidence of ongoing refinement of microfinance systems are, however, strong enough to leave no doubt that efforts in this area should be continued and refined.

Apart from the average economic rate of return to investment in microfinance institutions, three other issues have been particularly contentious: the need for financial sustainability, the extent to which microcredit reaches the poor, and the question of whether microcredit to poor women actually benefits them, in light of claims that males in the family often use women as an easy way to get funds for their own use, with the women winding up having to struggle to repay the loans, suffer increased strife within the family, or otherwise losing from the operation.

The goals of financial sustainability and good outreach to the poor are generally viewed as being, at least to some extent, in conflict with each other. Financial sustainability is not in principle either a necessary or a sufficient condition for success as defined above. But a strong case can be made for treating it as a key criterion for two reasons: first, if an institution is making losses, its continuing life is dependent on the often unpredictable availability of external funds; second, the goal of financial success encourages internal efficiency, which can raise the social as well as the private payoff to the activity. A common compromise on this issue is the view that subsidies are acceptable with respect to initial capital and to entry into new activities or markets, introduction of new instruments and other ventures which have some combination of above-normal risk and likely learning-by-doing, but is not acceptable for standard operating costs.

Since microfinance is typically seen as a policy instrument to fight poverty, it is natural that it be judged by how poverty-focused its benefits are. The share of borrowers who are under such commonly used international poverty lines as $1 per day or $2 per day varies widely, with most cases falling in the range 25-90 percent.[48] Concern that such programs do not necessarily or generally reach the poorest of the poor, while understandable and relevant, is often misplaced. Even if a given instrument does not reach a high share of that lowest income group, it does not mean that it has failed as a tool of poverty reduction. It may be that other

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[47] On this point see also Snodgrass (1996, 3).

[48] Westley (2001, 15) reports that for five microfinance institutions in Bolivia an average of 40 percent of clients were poor. In Peru's Mibanco the ratio was 28 percent. Ratios for Latin American credit unions ranged from 18 to 56 percent. He notes that these data understate the impact on the poor since they refer only to the firm owners and because some would have started poor but are no longer. Among the projects reviewed by Hulme and Mosley (1996, 110-112) for only two was this ratio under 25 percent and for those in Bangladesh (like BRAC and the Grameen Bank) it was very high. Cohen (2001) reports that though most MFIs serve a wide range of clients, the majority are clustered just above or just below the poverty line.

instruments, such as labor-intensive public works programs, are better suited to that difficult task.

Often the process of poverty reduction revolve less around raising the self-employment incomes of the poor than raising the demand for paid labor, which means that the indirect effects of microfinance when it creates jobs and raises productivity need to be taken into account, as do the growth of the SME sector and all labor-intensive activities (Pro-Poor Growth Guide) on the process of poverty reduction.

In short, microcredit may be the most promising direct poverty-reducing instrument for only a minority of families, but this is no reason to undervalue the substantial benefits that it does have. Continuing improvements in microfinance technology should widen the range of borrowers who can be successfully introduced to this form of support. But it is important that the health of the institutions not be compromised by overstretching their capacity in order to reach unrealistically far down the income scale.

Several of the criticisms which have been directed at microfinance—failure to do enough for the poor, failure to avoid negative repercussions of lending to women in strongly male-dominated societies, must be put in perspective in at least two respects. First, it should be no surprise that some of the poor would be missed or that there would be some negative side effects from a massive increase in the flow of credit to generally low-income people. The issue is not the qualitative presence of these problems or limitations but rather their quantitative importance. Second, expectations must be couched in cultural reality; some problems cannot be solved quickly and most features of a culture cannot be changed quickly.

So the issue is not whether quick and total solutions are found but rather whether there is movement in the right direction. What does constitute such movement is a complex issue requiring much careful study.

Such inherent limitations notwithstanding, policy can substantially increase the chance of reaching the poor and the near poor by not making programs too attractive to the non-poor through low interest rates and failure to insist on repayment. Absent such features, the non-poor are likely to do better with commercial credit, thus leaving such resources as do come though the microfinance system to the poor and the near poor (see the next section on BRI).

## D. A Major Success Story: The BRI Microfinance Program[49]

The Indonesian experience in microcredit is worth examining because of its growth rate, size and success. It may well be the largest, successful effort anywhere, in relation to the country's GDP. The same institution also had a large and successful program of SME credit. But that is less distinctive in either size or success and is therefore not analyzed in detail here. The successful expansion of MSME credit in Indonesia has its roots in 1983, when the public

[49] This section is based on Papanek.

sector Bank Rakyat Indonesia (BRI), in the wake of financial reforms and faced with mounting losses in its existing micro-credit unit,[50] decided on a serious commercial effort in microfinance. It launched a new "general purpose credit" (KUPEDES) program with a real interest rate of about 20 percent, sufficiently high to cover all costs, together with a program to provide facilities for savings (SIMPEDES) deposits. The program was dramatically successful. Outstanding small loans[51] by BRI alone rose by over one hundred-fold in current rupiah terms between 1984 and 2002. Small rural savings deposits increased even more dramatically, from negligible to Rp.1 trillion in 1989 (US$ 0.5 billion) and nearly Rp. 23 trillion in 2002. As of 1999 all savings accounts (mostly rural) in BRI alone came to three percent of national income.

The key to the success of these programs was their operation on a commercial basis and in a decentralized way; each rural unit was seen as a profit center and its performance was measured primarily by the usual criteria of private banks.

The following were key practices:

i) Market interest rates for both borrowers and depositors, with a margin sufficiently large to generate a profit after covering the high cost of administering small loans. In 1984, when interest on loans extended under the government's BIMAS program to encourage more rice production were at 12-15 percent the KUPEDES rate was 32 percent. Such rates served as a powerful signal to BRI staff, as well as to depositors and borrowers, that the Micro- and Small-loan programs and other services would be operated on a commercial basis. It also made it possible for lending to expand without requiring increased government appropriations to cover the deficit.

ii) Insistence on repayment of loans. Collateral was nominally required but could effectively be waived for first-time borrowers or those with small loans; BRI very rarely tried to actually seize collateral; though it did request that borrowers hand over the land certificates which provided the legal basis for ownership, this was mostly a means to establish that BRI was serious about collecting both interest and principal. Borrowers proved to be conscientious about repayment once they saw that BRI was serious about expecting repayment and others were also paying back.

iii) Decentralization of decisions and of responsibility, which involved several elements. First, micro-banking was set up as a separate unit within BRI. This made it possible to convince skeptics in top management and the Board that microfinance could be profitable, sometimes even while other units lost money. As a separate unit, it had managers whose career was tied to its success, with resulting effects on their incentives. Work in microbanking, once considered the least attractive area, took on a new appeal.

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[50] The losses were due to the typical combination of a highly subsidized borrower interest rate which made loans a perk for village elites, poor repayment records, and a deposit rate above the lending rate, making expansion of the credit program difficult.

[51] Depending on the exchange rate the dollar equivalent of these loans has varied from a minimum of $3 to $13 to a maximum of $3,000 to $13,500.

Second, each of the 3,700 bank offices handling microfinance was made a separate profit center whose performance could be individually tracked and evaluated. Each was expected, after a start-up period, to cover its costs and earn a profit. Since bank officers' performance was evaluated on the basis of this record there were strong incentives to expand deposits and loans and, above all, to compile a good record of payment of interest and repayment of principal.

Below the unit or bank offices there were cash posts, part-time and mobile BRI officers, who took deposits, paid out withdrawals and accepted loan installment. Banking was therefore convenient for a substantial part of the rural population, especially in the densely populated areas of Java and Bali, which had most of the offices. Finally, loan decisions were delegated to the local level for loans up to the limit of Rp. 25 million ($10,000 when the Rp. was at its strongest), giving responsibility and decision-making power to those with the best information. This worked well when combined with a monitoring and incentive system administered centrally, and an interest-rate structure that eliminated all rents.

iv) Ability to take deposits as well as making loans was another significant factor in BRI's success in both private and social terms. The very fact that BRI took deposits signaled that it was a serious commercial operation. The more direct and very important benefit reflected a need for liquidity on the part of poorer parts of the population and smaller firms which was as great as the need for loans. BRI provided a safe (government guaranteed) and liquid savings vehicle in the rural areas. This benefited not only the depositors but also those other parts of the economy to which these rural savings were transferred.

Shrewdly, BRI recognized that what mainly mattered from the point of view of efficiency was the availability of credit to the agricultural and rural business system as whole, not to particular groups such as farmers or particular groups of small businesses, because different groups extended credit to each other. Focusing on those groups that it is easier to deal with (whether because fewer in number, easier to assess creditworthiness, or generally more reliable) can improve overall performance of a financial system.

Other wise policies were to maintain flexibility on repayment periods and installments and to lend for any purpose. Although BRI preferred loans for productive purposes, it did not try to enforce such use, recognizing that policing a no-consumer-loans policy would be costly or almost impossible and not necessarily a good idea. This attitude facilitated the development of a long-time and solid customer-banker relationship.

Success was also due in part to factors outside BRI's control, including the high population density of Java and Bali where the bulk of its activities were based. Density greatly reduced the cost of operation, since a single office could reach a much larger pool of potential depositors and borrowers than in more thinly populated areas. Extension of services to other parts of Indonesia proved more difficult. The rapid growth of the economy (at an average of seven percent over 1967-1997) made for more prosperous businesses, on average, and hence less repayment problems.

How large have been the fruits of BRI's microcredit program? A pre-crisis survey reported that profits increased about 25 percent a year for enterprises that had borrowed for three years, because they could keep larger inventories, produce at a higher rate, with fewer stoppages because of inadequate cash flow. As a result household income increased 21 percent a year as compared to four percent for the average person in the rural areas (in the late 1980s). Employment in borrower enterprises increased 18 percent in terms of employees, and by 22.5 percent in terms of annual labor hours, with both family and hired workers benefiting.

A recent and methodologically stronger post-crisis evaluation by BRI and a Harvard University group concluded (i) that borrowers under the KUPEDES program performed and fared somewhat better than those with viable enterprises but who did not borrow from BRI, in terms of changes in business income, value of sales and numbers of customers, and therefore also in family income, but these differences are not statistically significant, and (ii) that borrowers did significantly better than non-borrowers without a viable business. Reported employment gains were much less in this post-crisis survey. Overall, these results suggest, at the very least, that BRI was providing part of a pool of funds whose effect was to significantly raise incomes of borrowing families.

The poverty impact of the program was primarily indirect, since most borrowers were not poor. According to a careful sample survey, regular borrowers from the BRI micro-banking system had incomes three to four times those borrowing principally from moneylenders, friends and relatives or a village bank. BRI has few borrowers who are women, widowed, older or with little education

For some, their income gains increased their chances of staying out of poverty if the economic environment turned adverse. The main impact on the poor would be through the absorption of some of the excess labor in the system thus exerting upward pressure on the wage rate, and perhaps from multipliers effects in the local labor market from the increase in incomes and economic activity. Papanek (Indonesia country study) concludes that these rural deposit and micro-lending programs made a useful, but small, contribution to poverty reduction.

## E. Some Recent Trends in Microfinance

As in any new industry, the early phase of microfinance development was characterized by both rapid overall expansion and considerable growing pains, including many cases of failure to achieve financial sustainability and some exits. Much has been learned and the current prognosis is broadly positive. Recent trends have, however, varied considerably by region and by setting.

Jansson (2001) notes that Latin America is leading the way in a process of professionalization and commercialization whereby microfinance, once dominated by small NGOs, is now led by formal profit-oriented financial intermediaries. These are downscaled banks and specialized financial institutions, which as of the late 1990s served as many clients and provided three times as much credit as the non-profit organizations (Cristen, 2000). As well as growing fast in Latin America (20-30 percent over 1998-2000) these institutions had better returns on assets (four to six percent over those years) than the two percent achieved by commercial banks. With the rise of commercialization comes a shift in the sources of funds feeding microfinance growth, with donor share declining in favor of deposits of the public and local and international creditors and social and commercial investors (Jansson, 2001, 14-5).

Two encouraging developments in Latin America are the spread of microfinance regulatory systems and the emergence of a few firms providing specialized assessment services for microfinance institutions, while gathering and synthesizing information on the industry as a whole. The pressure for regulatory legislation built from 1995 as several successful and fast growing nonprofit microcredit foundations sought to transform themselves into licensed and supervised intermediaries, usually finance companies and sometimes banks. During this same period, several microfinance institutions suffered serious liquidity and solvency problems, which also highlighted the need for regulation.

Meanwhile established banks and consumer finance companies began eyeing this segment of the market with greater interest. Both groups saw their potential hampered by lack of a regulatory environment taking account of the distinctive features of microfinance (Jansson, 2002, 4). Since 1999, 10 countries have adopted such legislation (Peru and Bolivia had done so before).

Trends and patterns have been different elsewhere. State banks have played a larger role in Asia, but the preponderance of self-help groups and other NGO models continues, combined with a more moderate rate of commercialization. Some of the state banks continue to offer lessons of interest on how to avoid the inefficiency which public institutions often suffer.

In Post-Soviet Eastern Europe banks have been increasingly engaged in microfinance, and the degree of commercialization has advanced rapidly. Sub-Saharan Africa remains the biggest challenge to generalized success but there are elements of hope. In Uganda there has been much experimentation and a trend towards commercialization. In South Africa, the industry has grown rapidly over the 1990s and commercial banks are attempting to move into the area, though with mixed results and implications.[52]

The HIV/AIDS crisis puts microfinance institutions under great strain, together with their borrowers, and will call for innovative solutions if the institutions are not to be serious damaged. Post conflict countries tend to have high rates of subsidization, not inappropriate in and of itself, but a practice which may sow the seeds of future repayment problems unless handled very carefully.

[52] Personal communication from Penelope Hawkins.

## F. CHALLENGES FOR THE FUTURE

The broad challenge to the various suppliers of microfinance is to raise efficiency, to extend the scope of operations, especially towards poorer clients when this is possible, and to increase the range of instruments available on both the deposit and the lending sides. The responsibility for success is shared between the microfinance institutions (MFI) themselves and the governments which set the rules and provide appropriate support, as well as developing infrastructure, financing training and making other expenditures complementary to the success of microenterprise and its growth into the SME size range.

Improving the average efficiency and hence the effectiveness of the various types of actors in the microfinance field involves raising the share of microfinance institutions that are performing well, and spreading the record of success to regions where the experience has not thus far enjoyed much, especially Africa. At present the largest microcredit institutions are in Asia. Two thirds of those that are self-sustaining are in Latin America, according to the April, 2001 Micro banking Bulletin.[53] Complementary to such progress would be an increase in the capacity and the reach of commercial banks, credit unions and other types of financial institutions in the small loans market.

To attain and/or maintain efficiency, MFIs need to follow existing best practice with respect to interest rates, repayment, and prudent use of subsidies. Such best practice has to be permitted and facilitated by good public policy. Two of the earliest breakthroughs to make microcredit systems feasible and sustainable were the recognition that a) the default rate can be kept very low, and b) low income people can pay high interest rates. Rates modestly above market levels in the formal sector and delinquency levels under 5 percent have proven adequate to permit financial sustainability in well managed MFIs. Financial success requires that discipline be instilled both in the borrowers and in the managers and staff of the MFI.

The fact that most MFIs are owned by NGOs or government agencies or are credit unions means that this motive is less systematically present than in profit-oriented private businesses. The availability of funds from external donors poses a dilemma for MFIs. If misused, such funds can subsidize inefficiency on the part of the MFI and/or laxness on the part of the borrowers. It is therefore important to establish firm and well thought out guidelines for their use. The resources should not underwrite subsidized interest rates but only capital and personnel start-up costs and (perhaps) transitionally high default rates.

Pressures for below-market interest rates arise from three main quarters. First, some advocates of microcredit as an anti-poverty tool favor subsidized interest rates as a general practice. While understandable, this view fails to reflect a broad understanding of the microcredit world. Second, in the case of credit unions, borrowers may have substantial influence over policy, and naturally tend to press for low interest rates. Third, when nominal

[53] Westley (2001, 19) notes that over half of the 124 microfinance institutions tracked by the Bulletin were financially self-sufficient. The Bulletin tends to track the stronger institutions.

market rates become very high, usually in a context of inflation or of very tight monetary policy (without inflation), both borrowers and others feel that they impose an unfair burden.[54]

In the former circumstance the argument is weak, since the real rate of interest is typically low under inflation and failure to charge it will quickly undermine the profitability of the MFI. In the latter case the issue is more delicate since failure to raise rates with those of the formal sector would not prejudice profitability and since a high real interest rate is a greater burden than a high nominal one. The risk of not following the market rates is that some microcredit will then go to non-poor, larger borrowers who would normally borrow from the more costly commercial banks, subverting its intent of serving smaller and poorer borrowers.

While sticking to what has worked to date, MFIs need to continue the search for effectiveness in new settings, with new groups of clients, and via new financial instruments. At the same time they (and policy-makers) need to recognize that credit, or credit in a particular form, is not always in the best interest of the potential borrower; accordingly some thought has to be directed to the risks of overborrowing by some clients. The setting within which many microenterprises (and SMEs) operate is undergoing change. For example, the very rapid growth of supermarkets in developing countries means that small suppliers confront monopsony power—only one effective buyer—with increasing frequency and may need special financial facilities in order not to be unduly squeezed as a result (Brand, 1999, iii). The shrinkage or demise of many state agricultural banks has opened up a market which will be shared by commercial banks and microfinance institutions.

Many financial products still being explored in the microfinance world are common offerings of conventional financial institutions and informal moneylenders. The trend involving new products is part of what Brand (1999, i) describes as a shift from the supply-driven products typically offered by most microfinance institutions to a client centered, market-driven approach." Finally, the way microfinance is purveyed will be affected by who is doing it. In Latin America at least, this means a general trend towards more formal financial intermediaries.

But both needs and trends vary by region and setting. Where MFIs are already serving large numbers of clients, a set of new issues and challenges is arising. Competition among institutions and an increase in client dropouts (that is, former clients who no longer borrow) is helping to replace the "unlimited demand" scenario of not so long ago, which produced the simple, standardized suppliers' product—the short-term working capital loan, with the client-driven approach (Cohen, 2001, 1).

The "dropout" problem is due in part to MFI's policies of requiring clients to take increasingly large loans each cycle; in other cases that pressure leads to the client's assuming too much debt, which raises the likelihood of default. The shift from the traditional focus on quantity to one which includes quality of services delivered is leading to much experimentation, recognition of the need to learn more about clients and their needs, and

[54] This problem has been particularly present in countries of Latin America, which have suffered bouts of inflation more frequently than have those of most other regions. Thus Colombia and Ecuador have recently reimposed interest rate ceilings, and some other countries have yet to remove them (Westley, 2001, 16).

should lead to a new range and richness of services and the inclusion of previously underserved groups.[55]

This new phase could have the effect of making microfinance lending a more pro-poor instrument than it has been thus far. But it also coincides with and may even contribute to some dangers that would have the opposite import. Two related features should help to raise the effectiveness of microfinance: a better understanding of the borrower's needs[56] and a higher level of competition among providers.

Cohen exemplifies the need for new products by noting that the existing standard package lacks a vehicle to respond to emergencies by delivering small amounts of cash quickly; when introduced (for example, in CVECA programs in Mali), this product has been very popular (Cohen and Sebstad, 1999).[57] Larger lump sums can also be very useful for poor people to reduce their vulnerability, to meet anticipated or unanticipated needs and to take advantage of opportunities (Rutherford, 2000; Cohen, 2001). Meanwhile, competition can speed the process of suppliers recognizing and satisfying client needs, and doing so at reasonable prices. New products may also imply new models of delivery.

The risk in the new situation is that the pressures of competing for clients, especially when it is not accompanied by a good understanding of their needs and overall debt situation, may have the effect of overloading clients with debt.

Daniels (2002, 34) describes the rapid growth of microfinance in South Africa from a very small base in 1990 to about 2 percent of total disbursements of the financial sector in 2000. He notes that the majority of the lending is for consumption and that there has been a sharp increase in the ratio of debt to income for the bottom income group between 1995 and 1999 while the opposite was happening for other income groups, giving rise to concern about the risks associated with a lack of experience with debt, and about the ability to repay of the poorer group, given that most of the credit is not used for directly income-increasing purposes.

Predatory lending practices and excessive expansionary zeal, along the lines of credit-card purveyors in industrial countries, may require attention in contexts like this one. Serious

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[55] To the extent that the very poor are ultimately included on a fairly large scale it will probably be the result of products tailored specifically to their needs.

[56] Sebstad and Cohen (2001) look at the poor's experiences with microfinance to demonstrate how the industry's financial services are used by clients to manage risk. The uses are varied, and microfinance is typically only one of several potential sources of funds, whose use must be understood in relation to the other sources. Chen and Snodgrass (2001) report that a sample of SEWA Bank borrowers in urban India lived in a complicated world of debt (in the sense that a high share of expenditures were financed by debt) and that SEWA was the source of only a third of their total borrowing. Dunn (1996) presents a useful review of the borrowing and debt patterns of households and microenterprises.

[57] Also exemplifying response to borrowers' needs (in this case changing needs) is the Grameen Bank's introduction of a "flexible loan" which gives the borrower greater freedom in the timing of repayment. It was created partly in response to repayment difficulties experienced by people who had borrowed in the wake of the severe floods of 1988 to rebuild their houses and start income generating activities (Yunus, 2002).

repayment problems in the near future may delay the development of a strong ethic of repayment.

In the past, most MFIs have operated on the assumption that a bigger flow of credit is good for both the borrowers and them. A refinement of this attitude is now needed. While most borrowers may be good judges of how far to go into debt, this will not always be the case if, again, we judge by the experience of credit card borrowing in developed countries. Particularly dangerous are situations like that of South Africa where microfinance rises quickly in a situation where overall credit was previously very scarce, such that borrowers hardly needed to think about the danger of over-indebtedness.

In other settings easy availability of credit may help to maintain some costly spending traditions (like lavish weddings and funerals) or to introduce new forms of status spending which help to keep poor people in debt and poor. MFIs should not only have a good understanding of the financial flows and the needs of their clients but also of their level of financial management skills.

One test of a microcredit system is whether on average it reduces the clients' recourse to expensive informal sources or, by creating a credit overload, ultimately increases that recourse. Since clients value their credit status with MFIs they may be inclined both to accept credit when they do not really need it, and also to put this lender at the front of the repayment queue. Catastrophic overlending may be unlikely since that would quickly harm the lender's profits, but some overshooting from the perspective of the client's welfare could easily occur. The risk that too easy access to credit may discourage savings might in part be alleviated by a strong effort to improve savings services.

Better MFI decision-making may flow from including clients as members of the Board (as with SEWA in India keeping bottom-up lines of communication open in other ways, and client monitoring systems, such as that of ADEMI in the Dominican Republic (Cabal, 1998).

Many MFIs have top-down information flows and a presumption that they are the "only game in town"; some suffer from patronizing attitudes of staff towards borrowers (Cohen, 2001, 14). Such settings are obviously unpropitious for the successful evolution of a more client-driven type of industry. Cohen (2001, 17) points to the AIMS/SEEP practitioner-led Client Assessment Tools and the MicroSave Africa's Market Research for Microfinance as useful and complementary items in the information gathering toolkit. Data collection must, of course, be complemented by its effective use in the analysis of options and problems.

An important advance, relevant for the larger and better-run microcredit institutions, is into the area of deposit-taking. Better savings options are important for many poor people in general, and the linkage with the credit function constitutes a natural package. The same microcredit institution which takes this step will often also be one which has the capacity to extend larger loans to firms which are graduating from microenterprise status to the next level up, another valuable function which is not available as often as would be desirable.

The regulatory and legal frameworks within which MFIs operate need to be brought into line with the evolving needs and opportunities of the sector. Adequate prudential supervision is a key to maintaining sound financial intermediaries, and most countries have a distance to go in this respect.[58] It is especially important for deposit-taking institutions: small depositors cannot be expected to evaluate the soundness of the entity which takes their deposits and will lack confidence in unsupervised institutions.

But even for MFIs that do not receive deposits, supervision may be desirable to encourage financial discipline and better provision of services, to open the door to deposit mobilization, and to avoid losses to institutions' borrowers (which may rely on it). One current view, however, is that non-deposit institutions should not be supervised, or if they are that it should be done by a self-regulatory organization. Typically, this view does not imply the absence of benefits from supervision, but rather reflects a judgment that external supervision would typically not be well enough applied to provide any net benefits.

When regulation is desirable or necessary, as with deposit-taking MFI, who should supervise and how it should be done? These are matters of ongoing experimentation and learning. Until fairly recently it was widely agreed that the existing bank superintendence should be charged with this responsibility, rather than creating a separate MFI or credit union agency (Westley, 2001, 24). Compared to alternatives that involve delegating some of the authority, it has the advantage of avoiding obvious conflict of interest problems.[59] It also, however, has several potential drawbacks.

Saddled with the main responsibility of protecting the integrity of the overall banking and payments system and given the very small weight of these MFI institutions in that system, the superintendence's attention to their needs may be both limited and erratic.[60] Unlike the supervisors dealing with large banks, who can focus on a subset of loans and quickly get a picture of bank status from the data-rich files, MFI supervisors need to understand the credit technology and the loan tracking system of each institution and of microcredit institutions in general. Since MFIs must be both quick and strict in their pursuit of delinquency, supervisors must be able to quickly identify overdue loans. MFIs and their supervisors need early warning indicators since, given the shortness of the loans, an institution's financial status can deteriorate very fast. Whichever system is adopted, the agency in charge should be given the authority to charge the members the full cost of the supervision. This adds only a few percentage points to the interest rate.

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[58] The World Bank has developed an approach to regulation of microfinance as part of a broader philosophy of financial regulation (see Van Greuning et al., 1998) which relates the need for and type of regulation and regulatory agency to the source of funds on which the MFI draws. The idea is to develop a transparent and inclusive regulatory framework within which MFIs can progressively evolve into formal financial institutions.

[59] Such delegation to Credit Union federations has been practiced in several countries of Latin America. Westley (2001, 26) cites a recent example from Costa Rica where the recommendations of a competent technical staff were routinely overturned by the representatives of the supervised credit unions. Such a pattern is predictable since many Credit Unions are borrower-dominated, hence want low interest rates with little or no analysis of ability or willingness to repay, and with low interest rates to depositors.

[60] Westley (2001, 25) cites as an example the fact that during Peru's 1998-1999 financial crisis MFI inspectors and analysts were reassigned to the banking system proper.

Together with a strong system of supervision should go a good set of regulations on minimum capital requirements, capital adequacy ratios (ratio of capital to risk-weighted assets), loan documentation and provisions, and governance system. The regulations established must reflect the features of the MFIs and Credit Unions (CUs). What would be appropriate documentation for each borrower from a commercial bank would be excessive for MFIs. The prudential banking regulations in many countries have been designed for large loan sizes and are inappropriate and counterproductive in the context of MFIs and CUs.

A well-designed regulatory framework benefits from a well-functioning legal system to complement it. A weak legal framework which impedes the use of both movable goods and real property as collateral may have its greatest damaging impact on loans to small firms rather than large or micro (Fleisig, 1995, cited by Westley, 2001, 31).

In many developing countries, including those in Latin America, the laws are quite limited as to which goods can be used as collateral. Creditors cannot automatically attach the proceeds if a pledged asset is sold, as in the United States or Canada. To be sure collateral has no prior superior claims the lender must be able to search in the legal registry. Where that registry is badly organized this can be a formidable task. Effective use of computers should be able to revolutionize the efficiency of such registries. Weak enforcement of security interests is common, with the effort and time expended often such as to discourage the creditor from pursuing this option. Such limitations are particularly detrimental to the use of movable goods as collateral, since their value can fall rapidly, or they may be sold or exported.

Leasing and factoring are often discouraged by legal, regulatory and tax impediments. In leasing, the financial institution which buys the piece of equipment to be used by a firm has in principle sole legal claim to that item; sometimes however it requires a legal process to reclaim the equipment since it resides on the firm's property. If interest payments are tax deductible but leasing rent payments are not, the latter practice will be discouraged.

Credit bureaus, which gather the credit histories of all banking system borrowers with loans above a certain size, are generally established by banking superintendence's to help in the business of supervision. The knowledge that default will become public can be a good incentive for repayment and a source of security to the lender.

Appropriate regulatory and legal institutions differ not only by type of financial institutions but also, no doubt, according to a country's broader cultural context. Attachment of collateral is seldom the recourse adopted by BRI when clients fall behind in their payments, and it appears not to be standard practice in group lending schemes that members of a defaulter's group do have to "pay up" on that person's behalf. Rules can be very useful without being systematically enforced. In specific cases and countries, therefore, such nuances need to be allowed for. A good first step is to see what is working and how rules are applied in similar cases to the one under discussion.

# CHAPTER FOUR
# POLICY RECOMMENDATIONS

The policy recommendations made here fall into one or more of three categories. First are regulatory or other proposals designed to steer institutions away from behavior patterns that are damaging or dangerous. Second are proposals designed to lower transactions costs and hence increase both the efficiency/profitability and the potential coverage of the institutions. Third are proposals designed to expand the coverage of financial institutions, with pro-poor effects. Some are relevant to microfinance, some are relevant to SME finance, and some are general.

## A. GENERAL

1. In no case should interest rates to the borrower be below market rates. This practice encourages rent seeking, on-lending to different uses than those intended, corruption, and sustainability problems. It tends to prevent the funds from reaching the intended users. Interest rates ceilings, where used at all, should restrict themselves to limiting predatory lending at rates far above the market.

2. Significantly positive real interest rates for small savers may lower poverty by acting as an inducement to their saving and to their creation of small enterprises. Support for informal savings groups and for multi-branched savings institutions (such as postal savings systems) is often useful.

3. Credit should never be forgiven. This practice promotes pernicious behavior patterns that can quickly erode the sustainability of a financial system and with it the potential to provide benefits to the intended clients.

4. Bankruptcy procedures should be developed to deal with borrowers whose businesses cannot meet their debts.

5. Governments should not provide credit directly, but should channel funds through the existing banking institutions. The former are too prone to corruption and inefficiency.

6. Public sector MFIs need to be organized and administered in ways which keep incentives for efficiency high and vulnerability to political pressures low.

7. Governments should not prejudice the long-run effectiveness of other MFIs by allowing or inducing some (for example, those in the public sector) to stray from such best practice principles as unsubsidized interest rates and strong pressures for repayment. The temptation to "soften" practices is especially prevalent under recessionary conditions.

8. Overall regulation and supervision of the financial system require improvement in nearly all countries. Numerous financial crises, bank failures, and other misadventures in

financial systems have imposed large costs on the poor, through (1) their role in producing macroeconomic recessions; (2) their negative impact on SME borrowers; (3) losses sustained by small depositors; and (4) the costs associated with the fact that rich stake-holders do not always bear their appropriate share of total losses and are bailed out by governments. Avoiding these costs involves a range of regulations and supervisory functions. One important step is the development of deposit insurance systems for small depositors only, with relatively low ceilings to avoid leakage of the benefits to larger savers who are in a better position to evaluate risk.

9. Improvements should be sought in the legal framework within which financial institutions operate. Many countries, for example, have no or ineffective laws on collateralization, which raises the transactions costs involved in lending.

10. Facilitation and possibly support for the creation of credit-rating agencies can be a useful complement to the financial intermediaries by helping to lower transactions costs.

11. Special (temporary) financial and other resources can be provided to help MFIs deal with the costs of learning[61] to move into new markets, serving new—and especially poorer—borrowers and savers; training assistance can be provided or funded; and acquisition of relevant information facilitated.

12. Along with the general desirability of more equal access to credit by firm size and technology used, it is also important to lessen the degree to which monetary contractions fall on the SMEs rather than on large firms, which are naturally viewed by most banks as the more important clients (and safer ones). Unstable credit access reduces the long-run competitiveness of the SME sector. Bearing credit crunches disproportionately has a stronger negative impact on employment than would be the case if the burden was more evenly distributed. Public policy might raise credit guarantees to SMEs at times of macroeconomic stress, although this would have to be done with care.

## B. Microfinance

1. The establishment and strengthening of sustainable microfinance programs—that is, programs with typical repayment rates of at least 95 percent—can help the poor by lowering their vulnerability to external shocks and providing a base for business growth.

2. Microfinance institutions should maintain lending rates at or higher than commercial bank rates and above interest costs.

[61] As Barham, Boucher and Carter (1996, 804) put it, "credit unions do not spring up merely because of the social need for better financial market intermediation for lower wealth depositors and borrowers. Start-ups require initial investments in organization, management training, membership recruitment, and creation of a healthy institution to attract depositors. These fixed costs may be large relative to the resources that a community can generate via collective action."

3. Programs that link microfinance to productive economic opportunities—for example, supplier credit in agriculture—warrant support. Such linking increases the chances that the microfinance will contribute to growth and sustainable income increases for the poor.

4. Governments may under some circumstances usefully finance training programs to strengthen microfinance institutions and the investment (but not operating) costs of moving into new areas, serving new groups, and innovating on collateral or other services or products.

## C. SME Finance

1. Commercial banks should be supported to raise effectiveness in their SME lending operations. Most commercial banks are relatively unskilled in their provision of credit to smaller enterprises. Support and inducements for them to upgrade their efficiency in this area can involve funding for training programs for loan officers specializing in small borrowers and assistance in the use of information technologies to lower the cost of monitoring such borrowers. To encourage them to provide services to SME it is far better to have them compete for funds for the training and investment to move into SME lending than to impose arbitrary quotas or subsidize operating costs. Competitive incentives means helping those best positioned and lowest cost banks to provide the services rather than forcing banks with no comparative advantage to provide services at high cost.

2. Capital support for the regional expansion of banks through the addition of new units in outlying geographic areas is advisable. Villages and small towns without credit and savings facilities tend to have potential borrowers for smaller loans. Provision of capital support only ensures that incentives will not lead to creation of units that cannot meet operating costs. Such regional extension provides better savings opportunities to small savers and assists small borrowers.

3. With capital support, bank lending should be extended into the SME area. Government financial support should be limited to one-off contribution to start-up costs of moving into this area. Institutions that take this step should create special departments for SME lending to facilitate the tracking of the growth, profitability, successes, and problems of such lending, and to guarantee good incentives and accountability.

4. Modest direct financial inducements to banks to lend to SMEs may be desirable, in the form of special funds available for on-lending to such clients. The implicit subsidies in such programs should be large enough to nudge lending behavior in this direction but not so large as to induce overindulgence. Funds should contribute to defraying above average transactions costs associated with smaller loans and newer clients but should not be allowed to support below-market interest rates.

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# APPENDIX A

The goal of the USAID-funded Pro-Poor Economic Growth Research Studies and Guidance Manual Activity is to identify and disseminate policies, reforms, and activities that USAID decision makers can incorporate into their programs and that they can recommend to countries wishing to pursue strongly pro-poor, poverty-reducing, economic growth objectives.



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